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UTILIZATION OF PENSION PLAN ASSETS IN LEVERAGED BUYOUTS AND RELATED TRANSACTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

APRIL 27, 1989

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UTILIZATION OF PENSION PLAN ASSETS IN LEVERAGED BUYOUTS AND RELATED TRANSACTIONS

THURSDAY, APRIL 27, 1989

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
FRIDAY, APRIL 7, 1989

PRESS RELEASE #6
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
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THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING
ON THE UTILIZATION OF PENSION PLAN ASSETS IN
LEVERAGED BUYOUTS AND RELATED TRANSACTIONS

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will conduct a hearing to review the utilization of pension plan assets in leveraged buyouts and related transactions.

The hearing has been scheduled for Thursday, April 27, 1989, beginning at 9:30 a.m., in the main Committee hearing room, 1100 Longworth House Office Building. Witnesses representing the interests of the Federal government, business, labor, retirees, and pension plans have been invited to present testimony at the hearing. Other interested parties are encouraged to submit written testimony to be included in the written record of the hearing.

In announcing the hearing, Chairman Pickle stated: "Earlier this year, the Committee on Ways and Means initiated a comprehensive review of leveraged buyouts and other forms of corporate mergers and acquisitions in an effort to determine their effect on all aspects of the American economy. In deciding what, if any, legislative actions should be considered in connection with leveraged-buyout transactions, it is important that the Committee have complete information on the extent to which such transactions may be jeopardizing plan participants' pension security.

"It is clear that pension assets play a variety of roles in leveraged-buyout transactions. What is not clear is whether the involvement of pension plan assets in such transactions is to the benefit of the plan participants.

"During the course of these hearings the Subcommittee will be considering several key questions:

1. When a company is the subject of a leveraged buyout, what is the effect of the transaction on the company's ability to maintain its previous pension commitments, and is there an increased likelihood that the company will terminate its pension plan in order to recover excess pension assets?

2. When a company is the target of a hostile takeover attempt, what is the appropriate role of pension plan trustees when voting on contested proxy issues?

3. In resisting a hostile takeover attempt, what defensive role can a company's pension plans play, and what is the effect of these defensive tactics on plan assets and plan participants?

4. As investors in leveraged-buyout pools, do leveraged-buyout transactions represent an unreasonable level of risk to pension plans?

5. As investors, does the use of high-yield, non-investment grade bonds (commonly called junk bonds), which are often associated with leveraged-buyout transactions, represent an unreasonable level of risk to pension plans?

"Serious concerns have been raised about the impact of leveraged buyouts on the retirement benefits which people have earned over the course of their entire working career. The long-term retirement plans of employers and workers ought not to be shattered in order to generate short-term profits for speculative investors."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Friday, May 26, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will **not** be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman PICKLE. The subcommittee will come to order. And we ask our guests to please take a seat.

Today, the Subcommittee on Oversight will examine the use of pension assets in leveraged buyouts and related transactions. It is important that the Congress and the public recognize that pension plans are major participants in every aspect of leveraged buyout transactions.

Pension plans as investors must find a productive way to use the nearly $1.2 trillion which workers and employers have set aside in their pension trust funds. One increasingly popular investment has been in leveraged buyout pools. It is these buyout pools which have so dramatically instigated the massive corporate takeovers we have all witnessed over the past few years. Another investment which has been made in ever-increasing volume is "junk" bonds. While less than 2 percent of all pension assets are devoted to these LBO investments, pension plans are, nonetheless, a significant source of financing for leveraged buyout transactions. We must ask ourselves, is this the right place to invest our Nation's retirement savings?

In addition, pension plans and their beneficiaries can be seriously affected when companies go through an LBO. The GAO has found that about 40 percent of the companies that sponsor pension plans terminate one or more of those plans when the company goes through an LBO. Since 1982, well over 100 pension plans have been terminated following an LBO of the plans' sponsors, and hundreds of millions of dollars have been taken out of these pension trusts and given back to the corporate sponsor. Here again, we must ask ourselves, is this a wise use of the Nation's retirement savings?

Finally, pension plans are beginning to raise their voices in shareholders' meetings all across the country. As major investors in corporate equities, private pension plans now own 18 percent of all the stock in U.S. corporations. The percentage is much higher in many of our Nation's "blue chip" companies. And with these holdings, pension funds have now become the true owners of America's corporate wealth. By the year 2000, pension plans will own 40 percent of all U.S. corporate equities. With the ownership of these shares comes the power to vote on a wide variety of shareholder issues. Increasingly, pension funds will be the deciding factor in the critical issues of corporate governance. In this role, they will play a critical part in determining the course of our national economy.

These are issues that cannot be ignored. From Main Street to Wall Street, from the White House to the courthouse, every citizen in every walk of life is directly affected today, tomorrow, and for the rest of our lives.

This morning, I am pleased to recognize the many distinguished witnesses who will be helping the subcommittee in its work.

Now, the Chair recognizes Mr. Schulze for any opening remarks he may have.

Mr. SCHULZE. Thank you.

I am pleased to join you in opening our hearing on the role of pension assets in LBO's. Earlier this year the full committee held hearings on the broad subject of LBO's. It considered the role of LBO's in our economy, and the role of the tax law in LBO's.

The LBO issue has many dimensions and many implications. Our vocabulary and discussions today will resemble what the full committee did a few months ago. But our emphasis will be different. We will focus on the effect of LBO's on pension plans.

For us, the spotlight will be on pension plans, whereas the full committee's spotlight has been on the LBO. I am anxious to learn the experience of pension plans which have invested in LBO's. Has the investment performance of pension plan portfolios been damaged by investing in high-yield junk bonds or trading in the security of LBO targets?

What are the fiduciary rules which govern the duty of a pension manager to accept the premium price of a tender offer? We also should evaluate the interplay between LBO's and overfunded defined benefit pension plans.

There have been allegations that the excess assets of overfunded plans make the company an attractive takeover target. This potentially could affect the employee in several ways.

First, the acquiring company might terminate the overfunded plan after the merger in order to recoup part of the takeover costs. Second, a company on its own initiative might terminate an overfunded pension plan as a way to diffuse a possible takeover bid.

The subcommittee should examine how much credibility there is to the allegation that LBO's result in more terminations of overfunded pension plans. But that question should not end our inquiry.

What has been the fate of employees in terminated plans? Do the acquiring companies establish new pension plans for employees, and how do the benefits in the new plans compare to the old pension plans?

The full committee will debate the policy question of whether LBO's are desirable or whether they should be restricted. Our focus is on whether or not LBO's are good for pension plans. If the full committee decides to limit LBO activity, then our subcommittee could help to shape the package.

Mr. Chairman, I look forward to hearing today's witnesses.

Chairman PICKLE. Do any of the other members have a statement?

Mr. McGrath.

Mr. MCGRATH. I appreciate your effort to assist the full committee by developing specific issues surrounding leveraged buyouts. Our topic today is extremely important to millions of Americans who depend upon pension plans for their retirement income.

As an insurer, the Federal Government also has a significant interest in the investment decisions and operations. After reviewing the materials and testimony we have received thus far, I am encouraged by the fact that pension fiduciaries appear to be appropriately cautious in making investments in LBO transactions.

The proportion in LBO's represents only a tiny fraction of the overall investments held by private pension plans. I believe, frankly, that only 1 percent of the pension assets of $2 trillion is invested in junk bonds, which are the major debt instruments in financing LBO's.

I know that good news does not often make headlines, but I hope that the record will show that in the majority of cases, pension

managers have acted in the interest of retirees. We should also keep in mind that the increasing use of leveraged buyouts to acquire or merge corporations will inevitably involve pension plans by virtue of their diverse investment portfolios.

Pension plans are more likely to become willing or unwilling participants in LBO transactions. On the other side, the effect of an LBO on a pension plan of a target corporation is an area which we must scrutinize more closely.

The security of retirees and pension insurance funds should not be jeopardized by an LBO. I look forward to hearing more on that matter from the GAO and others.

Again, I want to thank you for your leadership on this sensitive issue.

Chairman PICKLE. Thank you.

Mr. Shaw, do you have a statement to make?

Mr. SHAW. Mr. Chairman, I do not have a formal statement, but I would like to compliment you and Mr. Schulze in bringing this matter before the Oversight Subcommittee. Our full committee has been looking at the area of junk bonds and their effect upon the supply of capital as well as the effect on corporate America.

What was a prudent investment 10 years ago may very well be changing. I believe in the area of pensions, it is most important that we address that issue.

I would like to compliment you again, Mr. Chairman, for holding this hearing.

Chairman PICKLE. Thank you, Mr. Shaw.

Now, our first panel will consist of representatives from the Departments of Labor, Treasury and the PBGC. Our first witness will be Mr. David Walker, the Assistant Secretary for Pensions and Welfare Benefits. Then we will hear from Dana Trier, the tax legislative counsel with the Department of the Treasury. And then our friend, Dr. Kathleen Utgoff, representing PBGC.

Mr. Walker, if you would proceed first? All of your statement will appear in the record as submitted to us. You can proceed.

STATEMENT OF HON. DAVID M. WALKER, ASSISTANT SECRETARY FOR PENSION AND WELFARE BENEFITS, U.S. DEPARTMENT OF LABOR

Mr. WALKER. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am pleased to appear before you to discuss the views of the Department of Labor concerning certain issues relating to the involvement of pension plans in leveraged buyouts and corporate takeovers. I appreciate your including my entire statement in the record; it specifies in detail ERISA's requirements, and with your permission, I would like to present a summary of that statement.

The first thing I would like to do, Mr. Chairman, is to summarize the portions of my statement that address pension plan investments in junk bonds and leveraged buyout funds, and the relevant ERISA considerations with regard to tender offers and proxy voting, and then address the specific questions that the subcommittee had included in its invitation to Secretary Dole regarding this hearing.

To begin, let me discuss pension plan investments in junk bonds and leveraged buyouts. Because of the size and growth of pension assets, pension plans are playing an increasing role in the capital markets. As a result, they have become involved in leveraged buyouts and takeover battles.

Recently, there has been an increased public attention accorded to pension plan investments in leveraged buyout funds and non-investment grade bonds, so-called junk bonds issued by entities engaged in leveraged buyouts. Although some pension plans have participated as investors, our information about the degree of their participation is somewhat limited.

However, based on available data, we estimate that less than 2.5 percent of the over $2 trillion in public and private plan assets are invested directly or indirectly in junk bonds.

The data on pension plan investments and leveraged buyout funds are also somewhat sketchy, but we estimate that no more than one-half of 1 percent of public and private pension plan assets are invested in leveraged buyout funds.

In addition, we know that the 200 largest private and State and local funds hold approximately $3.5 billion in leveraged buyout funds, and two-thirds of these investments are held by State and local governmental plans which, as you know, are not subject to regulation by ERISA.

In fact, with regard to pension plan investments in so-called junk bonds, a majority of those investments, to the extent if they are held by pension plans, are held by State and local funds which, again, are not regulated by the Employer Retirement Income Security Act. In addition to these aggregate numbers, we know of no individual defined benefit plan that has a significant portion of its assets in either high-yield bonds or leveraged buyout funds.

There is nothing in ERISA that precludes these types of investments if they are otherwise consistent with ERISA's requirements that plan investments be made in the beneficiary's interests, be prudent and diversified so as to minimize the risk of large losses.

Consistent with these rules, before making any investments in junk bonds or leveraged buyout funds, a plan fiduciary must determine whether they comport with the requirements. From the evidence we have been able to gather, it appears to be working well. We recognize that these types of investments have burgeoned in the last few years and have not been tested by a full market cycle.

We will continue to monitor the situation. It is the Department's view, however, that any legislation that would single out private pension fund investments for selective treatment with respect to investment activity could adversely affect the long-term health of pension plans.

This could have adverse consequences for the security of our retirement system. Given the small percentage of private pension plan assets invested in leveraged buyout funds and junk bonds, we do not believe that any related changes in ERISA are necessary or appropriate.

With regard to tender offers: Tender offers present planned fiduciaries with an investment decision. In those situations where a plan fiduciary is considering whether or not to tender shares or the planned sponsor is the target of a takeover attempt, the fiduciary

must insure that his decision is based on what is in the economic interest of the plan, recognizing the plan as a separate and distinct legal entity established for the purpose of providing retirement income and security.

In addition, fiduciaries must be alert to and resist any attempt by corporate management to use the assets of their plans either as an offensive or defensive tool in takeover battles. Some have asserted that the threat of hostile tender offers often leads corporate management to satisfy short-term demands of the market at the expense of investing in long-term projects such as R&D.

Some argue that the investment behavior of pension plans facilitates hostile tender offers because the plans might be willing to tender their shares to any bidder offering even a small premium over market price.

We know of no empirical evidence that pension plans covered by ERISA are acting in any other manner or other institutional investors who may be expected to take a long-term outlook, given their inherent nature.

Furthermore, it is the Department's view that plans are not required to tender their shares. Specifically, they do not have to take the "quick buck" if they believe—based upon a thorough and objective analysis, it is reasonable to anticipate that they will achieve a higher economic value by holding that investment than by tendering or selling into the market and re-investing the proceeds.

With regard to proxy voting, the fiduciary act of managing plan assets, which are shares of corporate stock does include the voting of proxies associated with those shares of stock. In voting, the actions of plan fiduciaries must be based upon what is in the economic interest of the plan.

Other factors, such as the interest of corporate management, jobs, and other social contributions or any other business relationships of the fiduciary must be incidental to and cannot compromise the fiduciary's required economic decision.

It is the Department's view that ERISA requires fiduciaries to make individual investment decisions based on the facts and circumstances. The Department believes that they must carefully scrutinize all proposals which could have an effect on the economic value of the stock held by the plan and should fully and properly exercise their proxy voting responsibilities.

Now, Mr. Chairman, if I can, I would like to address the questions that you posed to the Department in your letter of invitation to Secretary Dole. With regard to use of pension plans as defensive measures, you asked to what extent is it acceptable for a company to design its pension plans so as to make it more difficult for the company to be acquired through a hostile takeover.

In light of the voluntary nature of our private pension system, which is covered by ERISA, the Department has concluded that there is a class of discretionary activities which relate to the formation rather than the management of plans.

These so-called set-forth functions relate to the establishment, termination and design of pension plans. Therefore, a decision to establish a certain type of plan, for example, an ESOP, or amend an existing plan as a defensive measure would not be a fiduciary decision subject to Title I of ERISA.

In this regard, it should be noted that some companies have voluntarily imposed restrictions on the use of residual plan assets in certain takeover situations. For example, some employers have amended their plans to restrict or prohibit reversions subsequent to a takeover or LBO.

Plan sponsors who are considering such amendments to their plans to impose those related restrictions should be fully aware of the implications of their actions. To the extent that such actions create promises of benefits, they may be called upon to make good on such promises, and the Department of Labor is engaged in litigation in one case to ensure that the employer does make good on their promise.

With regard to conflicting interests, you have asked what guidance the Department has given to fiduciaries to help resolve potential conflicts of interest they face when they are also officers of a company that is subject to a hostile takeover attempt.

The Department has recently issued two letters and has provided various other forms of guidance which describe and explain the duties of fiduciaries in proxy voting and tender offer situations.

In fact, there was a joint statement issued by the Department of Labor and Treasury in January of this year which is on point with regard to this issue.

We have also expressed our position through litigation, when we have felt that ERISA has been violated. In this regard, the Department continues to review and monitor transactions involving the use of pension assets in takeover situations.

We have undertaken a number of actions to ensure compliance. In various instances, the Department has taken action by filing a civil complaint in Federal District Court alleging that actions of fiduciaries had breached ERISA, by participating in private civil litigation to express the Department's views in court, and by expressing the Department's views in letters to fiduciaries alerting them to the Department's concerns in particular circumstances.

The Department is committed, Mr. Chairman, to assuring that the Nation's retirement security is not mortgaged. We do not want pension plans to be used as tools in corporate takeover battles. We recognize that the stakes are high, the temptations great and the potential for conflicts of interest are heightened in these transactions.

We are dedicated to continue to look at these areas and to taking appropriate actions when we feel that ERISA may have been violated. Finally, Mr. Chairman, you have asked whether it is determined that leveraged buyouts lead to an unacceptably high level of defined benefit plan terminations, whether additional restrictions should be placed on leveraged buyout transactions or the use of assets in pension plans.

We feel, Mr. Chairman, it is important to determine the degree of correlation between leveraged buyouts and takeovers with plan terminations before determining what, if any, additional actions may be appropriate.

In this regard, currently available data do not indicate that the availability of excess assets in the target company's pension plan in and of itself drives takeovers or leveraged buyouts.

I understand that Executive Director Utgoff of the PBGC will testify on plan stability issues and will note the preliminary results of the study they are conducting on the correlation between terminations involving asset reversions and LBO's. We believe this is an important study. It needs to be completed.

We also believe additional data needs to be analyzed regarding the correlation between plan terminations involving reversions and overall merger and acquisition activity. As a result, we—that is, the Pension and Welfare Benefits Association—will be looking into this broader issue in the coming months.

In conclusion, the Department will continue to vigorously enforce ERISA's requirements that plan requirements are made on the basis of what is in the economic interest of plan participants and beneficiaries. We will also continue to evaluate the issues and implications relating to takeovers and leveraged buyouts to determine what, if any, additional actions or recommendations may be appropriate.

I thank you, Mr. Chairman. That completes my summary. I would be more than happy, either now or at the conclusion of my colleagues' remarks, to answer any questions you might have.

Chairman PICKLE. We thank you, Mr. Walker, for your leadership in the pension field. We remember the cooperation you gave this committee as we considered pension reform in the last session of Congress. We are going to reserve any questions for you until we have heard from the other two witnesses.

[The statement of Mr. Walker follows:]

STATEMENT OF
DAVID M. WALKER, CPA
ASSISTANT SECRETARY FOR PENSION AND WELFARE BENEFITS
U.S. DEPARTMENT OF LABOR
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

April 27, 1989

I. INTRODUCTION

Mr. Chairman and members of the Subcommittee, my name is David Walker. I am the Assistant Secretary of Labor for Pension and Welfare Benefits.

I am pleased to appear before you today to discuss the views of the Department of Labor concerning certain issues relating to the involvement of pension plans in leveraged buyouts and corporate takeovers. In addition, my testimony is intended to be responsive to several specific questions the Subcommittee has asked us to address.

Pension funds may be affected by leveraged buyouts in two respects. First, pension funds may be affected in their capacity as investors of assets held in trust for the plan participants. Secondly, the stability of a pension fund may be affected by a takeover or leveraged buyout involving its plan sponsor. Our discussion will focus on pension plans in both of these situations and other selected issues.

The Department of Labor (the Department) has responsibility for the administration and enforcement of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), governing the regulation of private employee benefit plans. There are approximately 42 million workers covered by 870,000 private pension plans and 65 million workers covered by approximately 4.5 million private welfare benefit plans. All together, ERISA plans, including pension, health and welfare plans, hold over $1.7 trillion in assets, with ERISA pension plans holding over $1.5 trillion of this. Therefore, the Department has a strong interest in issues related to employee pension and welfare benefit plans, and is especially interested in assuring that such plans are not abused and are managed in accordance with the fiduciary responsibility provisions of Title I of ERISA.

Because of the size and growth of pension plan assets, pension plans play an ever increasing role in the capital markets. Private pension plans currently hold approximately 18 percent of total corporate equity and 26 percent of total corporate debt. Corporate equity and corporate debt holdings constitute approximately 36 percent and 27 percent, respectively, of private plan assets. Given their size and growth, pension plans inevitably have become participants in leveraged buyouts and corporate takeover battles.

Although some pension plans have participated in takeover and leveraged buyout transactions as investors, our information about the degree of their participation is somewhat limited. However, we do know that less than 2 percent of the total assets held by public (i.e.,state and local) and private pension plans that are not funded through insurance contracts are invested in high yield, non-investment grade bonds (so called "junk bonds"). The pension promises of plans funded through insurance contracts are backed by insurance company reserves. These reserves are invested in a variety of products, including high-yield, non-investment grade bonds. Allocating high-yield, non-investment

grade bonds held as insurance company reserves on a pro-rata basis to these pension plans, we estimate that 3.8 percent of the assets that back the promises of insurance contract funded plans are held in high yield bonds. If the direct holdings of high yield bonds of noninsured plans are added to the indirect holdings of group insured plans, we can calculate that less than 2.5 percent of the over $2.0 trillion in public and private plan assets are invested in junk bonds.

The data on pension plan investments in leveraged buyout funds are likewise somewhat sketchy. We do, however, estimate that no more than one-half of one percent of public (i.e., state and local) and private pension plan assets are invested in leveraged buyout funds. In addition, we know that the 200 largest public and private plans hold roughly $3.5 billion in leveraged buyout funds and that two-thirds of these investments in 1988 were held by state and local governmental plans. We also know that estimates of total pension investments in leveraged buyout partnerships and leveraged buyout commitments range from somewhat under $4.0 billion to almost $12 billion. The Department does not believe that either the low estimate or the high estimate is reliable. More specifically, we believe the actual amount of pension funds involved directly in leveraged buyouts is probably somewhere between the two, and is probably reasonably close to the $4 billion end of the range. In addition to these aggregate numbers, we know of no individual private defined benefit plan that has a significant portion of its assets in either high-yield bonds or leveraged buyout funds.

Before discussing the Department's views concerning various aspects of pension plan participation in leveraged buyouts and takeovers, I would like to discuss ERISA's general fiduciary responsibility requirements relating to all plan investments.

II. BACKGROUND

The investment of plan assets is subject to the fiduciary responsibility rules of Title I of ERISA. These rules provide, among other things, that plan fiduciaries (which include those individuals or entities who exercise discretionary authority or control over the management of plan assets) must act with the care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would use. ERISA requires that plan assets be used solely in the interest of the participants and beneficiaries of such plans, and for the exclusive purpose of either paying benefits or defraying reasonable expenses of administering the plan. ERISA also generally requires that plan assets be diversified so as to minimize the risk of large losses. All decisions concerning plan investments, including investments related to leveraged buyout and corporate takeover activity, must be judged under ERISA's prudence, exclusive purpose, and, where applicable, diversification rules. Therefore, fiduciaries of a pension plan covered by ERISA must ensure that their decisions are based on what is in the economic interest of the plan as a separate legal entity designed to provide retirement income security. It is the Department's view that, while ERISA does not direct fiduciaries to make particular investment decisions, it does require plan fiduciaries to consider the economic merits of each investment and to determine whether, based on the plan's portfolio and its particular needs, the investment provides a return consistent with the financial risk involved. Moreover, pension plan fiduciaries have an ongoing responsibility to monitor the performance of the underlying investment.

III. PENSION PLAN INVOLVEMENT IN LEVERAGED BUYOUTS AND TAKEOVERS

Because pension plans have become major participants in takeover battles, plan fiduciaries may be called upon to make decisions with respect to tender offers for shares of stock held in the pension funds' portfolios whenever there is a leveraged buyout or a tender offer. In constructing a portfolio appropriate

for the plan, pension plan fiduciaries may be required to decide the appropriateness of their plan participating directly in a leveraged buyout, participating indirectly, through purchase of a limited partnership interest in a leveraged buyout fund, or investing in debt issued by entities engaged in leveraged buyouts.

Whether the issue is investing plan assets in leveraged buyout limited partnerships or in high yield, non-investment grade bonds; deciding whether or not to tender stock held by the plan during a hostile takeover; or voting proxies of stock held by plans in takeover situations, ERISA fiduciaries of plans participating in leveraged buyouts and takeovers must ensure that their actions are consistent with ERISA's fiduciary responsibility requirements.

I would now like to address the ERISA implications of certain types of plan involvement in leveraged buyouts and other types of corporate takeover activities.

IV. ERISA IMPLICATIONS OF PENSION PLAN INVOLVEMENT IN LEVERAGED BUYOUTS AND TAKEOVERS

INVESTMENT OF PLAN ASSETS IN JUNK BONDS AND LEVERAGED BUYOUT LIMITED PARTNERSHIP FUNDS

There has been increased public attention recently accorded to the investment of pension plans in junk bonds and leveraged buy-out funds issued by entities engaged in leveraged buyouts, and questions have been raised as to whether plan assets should be so invested.

While there is nothing in ERISA that would automatically preclude such investments if they are otherwise consistent with ERISA's requirements, plan fiduciaries should carefully determine whether or not their plans are capable of bearing any increased risk and reduced liquidity associated with making such investments, keeping in mind ERISA's requirement that plan fiduciaries must diversify plan investments so as to minimize the risk of large losses.

The ability of a plan fiduciary to diversify, and to pursue different investment strategies, is important in maintaining the stability and security of a pension fund. ERISA allows investments in high risk vehicles, such as venture capital, highly leveraged real estate, or "junk bonds", as part of an overall investment strategy. Many economists believe that, through a broad-based, diversified portfolio, it is possible for a pension plan to simultaneously take advantage of economic growth while protecting against losses in times of recession, thereby ensuring the overall long term stability of the fund.

The legal environment which ERISA created, which allows plan fiduciaries a great degree of discretion in structuring investments of their plans, provided that they be economically prudent for the plans, appears to be working well from the evidence which we have seen. We recognize that some of these investments have not been subject to a full market cycle. We obviously will continue to monitor the situation. It is the Department's view, however, that any legislation that would single out pension fund investments for selective treatment with respect to investment activity could adversely affect the long term health of pension plans. This could have adverse consequences for the security of our retirement system. Based on the above and given the small percentage of private pension plan assets invested in leveraged buyout funds and high-yield, non-investment grade bonds, we do not feel that any related changes in ERISA are necessary or appropriate at this time.

TENDER OFFERS

Tender offers present a plan fiduciary with an investment

decision. Thus, when a plan fiduciary is considering whether or not to tender shares in a tender offer situation where the plan sponsor is the target of a takeover attempt, the fiduciary must ensure that its decision is based on what is in the economic interest of the plan, as a separate and distinct legal entity established for the purpose of providing retirement income security. In this regard, it should be noted that fiduciaries must be alert to, and resist, any attempts by corporate management to use the assets of their own plans either as offensive or defensive tools in takeover battles. The Department has spoken out on this issue and brought related litigation when we have found that ERISA's rules have been violated. We will continue to be particularly watchful for possible abuses in this area.

ERISA PLANS AND LONG TERM INVESTMENT

Some have asserted that the threat of hostile tender offers often leads corporate management to try to satisfy short-term demands of the market at the expense of investing in long term projects such as research and development. Some also argue that the investment behavior of pension plans facilitates hostile tender offers because these plans are willing to tender their shares to any bidder offering even a small premium over market price. We know of no empirical evidence that pension plans covered by ERISA are acting in any different manner than non-ERISA covered pension plans or other institutional investors who may be expected to take a long term outlook. In addition, it is the Department's view that plans are not required to tender their shares if, based upon a thorough, and objective, analysis, it is reasonable to anticipate that they will achieve a higher economic value by holding the investment than by tendering or selling into the market and re-investing the proceeds. In this regard, in January, 1989, the Departments of Labor and Treasury issued a Joint Statement which reiterated the Department's views concerning the application of ERISA to employee benefit plan behavior in tender offers and other related issues.

PROXY VOTING

Much attention has been focused recently on proposed anti-takeover charter amendments which are intended to prevent takeovers, and questions have been raised as to how plan fiduciaries should consider voting on them. The fiduciary act of managing plan assets which are shares of corporate stock includes the voting of proxies associated with the shares of stock. In voting, the actions of plan fiduciaries must be based on what is in the economic interest of the plan. Other factors, such as the interests of corporate management, jobs, other social considerations or any other business relationships of the fiduciary must be completely subordinate to the fiduciary's required economic decisions.

While the Department takes no position as to whether fiduciaries should vote for or against management or how they should vote on particular issues, it is the Department's view that ERISA requires fiduciaries to make individual investment decisions based on the facts and circumstances. The Department believes that these proposed charter amendments should be carefully scrutinized.

USE OF RESIDUAL PENSION FUND ASSETS BY CORPORATIONS INVOLVED IN TAKEOVERS

In light of the voluntary nature of the private pension system governed by ERISA, the Department has concluded that there is a class of discretionary activities which relate to the formation, rather than the management, of plans. These so-called "settlor" functions include decisions relating to the establishment, termination and design of plans and are not fiduciary activities subject to Title I of ERISA.

When a plan sponsor decides to terminate an overfunded pension plan in order to recapture any residual assets held in the pension trust, Title IV of ERISA imposes certain requirements. In addition, certain decisions relating to the implementation of the plan termination involve the exercise of fiduciary responsibility (e.g., the purchase of annuities; the proper implementation of plan provisions relating to a reversion). However, once these requirements have been met, the employer's proposed use of the excess assets of the plan which it recovers is not subject to review under ERISA.

You have asked whether, if it is determined that leveraged buyouts lead to an unacceptably high level of defined benefit pension plan terminations, additional restrictions should be placed on leveraged buyout transactions or the use of assets in pension plans. We feel it is important to determine the degree of correlation between leveraged buyouts and takeovers and plan terminations before determining what, if any, additional actions may be appropriate. In this regard, current available data do not indicate that the availability of excess assets in a target's pension plan, in and of itself, drives takeovers or leveraged buyouts. We understand that the Pension Benefit Guaranty Corporation (PBGC) will testify concerning the effect on plan stability in leveraged buyout situations and will note the preliminary results of the study they have conducted on the correlation between asset reversions and leveraged buyouts. Additional data needs to be gathered and analyzed regarding the relationship between reversion and overall merger and acquisition activity. PWBA will be looking at this broader issue in the coming months.

In this regard, it should also be noted that some companies have voluntarily imposed restrictions on the use of residual plan assets in certain takeover situations. For example, some employers have amended their plans to restrict or prohibit reversions subsequent to a takeover or LBO. Plan sponsors who are considering amending their plans to impose such restrictions should be fully aware of the implications of such actions. To the extent such actions create promises of benefits under their plans, they may be called upon to make good on such promises. The Department is currently litigating one such case, in Dole v. Graniteville.

It should also be noted that recent changes in the law may have affected activities in this area. For example, the Tax Reform Act of 1986 imposed a 10% excise tax (subsequently raised to 15% in 1988) on reversion amounts. This represented a partial recapture of tax benefits attributable to an employer's using tax-favored pension contributions for some purpose other than the provision of retirement income. Also, the Omnibus Budget Reconciliation Act (OBRA 1987) addressed perceived abuses in this area by: requiring a 5 year delayed effective date for pension plan amendments authorizing a reversion where the plan document did not previously provide for a reversion to the employer; revising the rules for calculating benefit amounts at termination and the rate of return attributed to participant contributions; and imposing new requirements on the reasonableness of plans' actuarial assumptions.

The Department believes that the likely effect of the self-imposed corporate restrictions in this area, as well as the restrictions on reversions that have recently been legislated, will be a further decline of reversion activity.

I would now like to address the Department's review of transactions involving the use of pension assets in takeover situations.

VI. DEPARTMENTAL REVIEW OF TRANSACTIONS INVOLVING THE USE OF PENSION ASSETS IN TAKEOVER SITUATIONS

The Department continues to review and monitor

transactions involving the use of pension assets in takeover situations, and has undertaken a number of actions to ensure compliance with ERISA.

The Pension and Welfare Benefits Administration (PWBA) has been involved in situations where fiduciaries have used employee benefit plan assets in an improper way as an offensive or defensive tactic in the purchase and sale of securities either to advance the objectives of an acquiror or to defend against an acquisition. In addition, in the broader context of corporate governance, PWBA has been involved in issues that relate to the voting of proxies in shareholder proxy contests. In various instances, the Department has taken action by filing a civil complaint in federal district court alleging that the actions by fiduciaries breached the fiduciary provisions of ERISA, by participating in private civil litigation to express the Department's views to the court, or by expressing the Department's views in letters to fiduciaries thus alerting them to Departmental concerns in a particular circumstance.

Use of Plan Assets as an Offensive or Defensive Tactic

ERISA requires that plan assets should be used for the exclusive purpose of providing benefits to plan participants and beneficiaries or defraying reasonable expenses of the plan. In assuring that plan fiduciaries comply with this requirement, the Department has participated as an amicus in the private action of Leigh v. Engle and was plaintiff in Donovan v. Simmons, both of which involved the use of employee benefit plans to achieve the takeover interests of the acquiror who controlled the sponsors. When Chicago Pneumatic created an ESOP during the course of a tender offer and gave it a substantial number of shares in the plan sponsor, the Department filed a civil action challenging the independence of plan fiduciaries who were to decide whether to tender the plan's shares (Brock v. Latimer). One lawsuit filed by the Department successfully challenged the purchase by a Grumman employee benefit plan of Grumman Corporation stock in the midst of a takeover attempt of Grumman by LTV Corporation (Donovan v. Bierwirth). In Dole v. Graniteville, which is currently in litigation, the Department has alleged that fiduciaries of an ESOP violated ERISA by failing to enforce the sponsor's promise to use any residual assets from a defined benefit plan termination to purchase stock for the ESOP.

Use of ESOPs and Leveraged Buyout Transactions

The Department has intervened in certain instances to ensure that plan participants are protected when an ESOP is involved in a leveraged buyout transaction. In these transactions, the Department is concerned that the ESOP is properly represented, that the price paid for any stock in the public company meets ERISA's "adequate consideration" requirement and that ERISA's other fiduciary requirements are met. The Department has written letters to trustees of employee stock ownership plans expressing its views as to the decision making process and allocation of ownership interests in circumstances which included an ESOP as a party to a going private transaction. Such situations arose in Scott & Fetzer, Raymond International and Blue Bell. In each of these situations, the Department's involvement either led to the transaction being restructured to the benefit of the ESOP, or the transaction not being effectuated. The Department is currently working on providing additional guidance relating to the use of ESOPs in leveraged buyouts involving multiple investors.

The Subcommittee raised certain questions regarding certain defensive tactics relating to qualified plans that companies are using to resist a hostile takeover attempt. We are aware of the current interest and activity in this area. We are also aware of the rise in the number of ESOPs being

established by major companies for the apparent reason of adding to their arsenal of anti-takeover weapons. As we have consistently stated over the years, ERISA's fiduciary decisions do not include decisions relating to the establishment or design of a plan, but relate to the responsibilities of plan fiduciaries once a plan or amendment has been put into place. For example, the decision to pay a particular price for stock, and the decision to honor pass-through voting/tender provisions in a plan document are subject to ERISA's fiduciary requirements. Obviously, we will continue to monitor this area to ensure compliance with ERISA's requirements.

Voting of Proxies by Employee Benefit Plans

ERISA requires that plan trustees have the exclusive authority to manage and control plan assets, unless an investment manager is appointed or unless the trustee receives proper directions from a named fiduciary. The Department has expressed its view as to the trustee's duties with respect to the voting of proxies at a corporate shareholders meeting or in a tender offer context in letters from the Department (letters regarding the Carter, Hawley, Hale tender offer and the Avon Corporation Retirement Plan, and also in a letter dated February 23, 1989, in a matter in which the Department has an open investigation). In addition, the Department has expressed its views in private litigation regarding the voting provisions of plans of Eastern Air Lines that were involved in a takeover attempt by Texas Air of Eastern Air Lines (Harris v. Texas Air).

With respect to both proxy voting and tender offers, we have found an increasing tendency on the part of plan sponsors to provide for pass through of voting and tender decisions for stock held in individual account plans. We have stated, in general, that plan trustees can accept such direction from participants but only if they are proper and not otherwise in violation of Title I of ERISA. With respect to unallocated or allocated but non-voted shares of stock, the Department has stated that plan trustees may follow plan provisions which state how such stock is to be disposed of, only in so far as such provisions are consistent with Title I of ERISA. Therefore, a plan trustee would have to determine, among other things, if following such plan provisions would result in a prudent investment decision and would provide a result which would be for the exclusive purpose of providing benefits to the plan participants and beneficiaries.

In addition to issuing guidance for fiduciaries voting proxies for shares owned by plans, in May of last year, the Department undertook a limited enforcement review project designed to monitor how fiduciaries were exercising their duties under ERISA with respect to proxy voting. PWBA selected certain investment managers, including financial institutions, who are responsible for managing significant amounts of stock in companies which had contested proxy issues during last year's proxy season. We believe that this important project provided a unique opportunity for the Department to educate the investment management community as to their duties in voting proxies under ERISA and has significantly increased compliance with ERISA in this area.

VII. CONCLUSION

The security, stability, proper funding and credibility of our private pension system must be assured. The Department will continue to vigorously enforce ERISA's requirements that plan investments are made on the basis of what is in the best economic interest of the plan participants. We will also continue to evaluate the many issues and implications of pension plan involvement in takeovers and leveraged buyouts to determine what, if any, additional actions or recommendations may be appropriate.

Chairman PICKLE. The next person we will ask to testify will be Mr. Dana Trier, representing the Department of the Treasury.

Mr. Trier.

STATEMENT OF DANA L. TRIER, TAX LEGISLATIVE COUNSEL, OFFICE OF TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. TRIER. Thank you very much, Mr. Chairman.

In order to avoid duplicating much of what David Walker has set forth, I will confine my remarks to two of your questions:

The first is the extent to which an overfunded pension plan or pension plan with reversion possibility increases the likelihood of LBO's.

The second is the extent to which there is a policy problem relating to termination of pension plans after an LBO.

As to the first question, I think it is fair to say that there is some reason to believe that the presence of potential reversion or excess assets after reversion does increase the attractiveness of an LBO target.

The primary reason for that is that excess asset represents very liquid, almost cash-like assets of the target. It can facilitate the LBO by virtue of helping pay off the debt even if a price is paid for those excess assets.

However, as Mr. Walker indicated earlier, there is absolutely no evidence that I know of to indicate that, in fact, the main reason for any large number of LBO's, especially in this climate, is the excess assets.

And I would like to reiterate that we really haven't seen the full results of the special legislation relating to reversions that was passed recently in which there is a 15 percent excise tax.

I would think that legislation, together with other measures, has probably decreased the overall respects in which the potential for reversion increases LBO activity. So I would also support his view that we go slowly in this area and not look at this as the fundamental problem that is increasing LbO activity.

As to the second issue which is one asked in an empirical matter that Kathy Utgoff will discuss, is the issue of whether, in fact, after the LBO occurs, there is a greater likelihood of pension plan termination.

Her testimony indicates, and she will describe in some detail, that it appears preliminarily that there is, in fact, more likelihood of pension plan termination. It is an issue that I think we all ought to continue to be monitoring and looking at.

However, I would like to say a few things that should make us go slow. First, it is not absolutely clear what single cause there is of that. After LBO transactions, there may be the necessity to pay off the debt and get the reversion, and that may be the cause of it.

There also may be other factors involved. As you know, many LBO transactions are so-called breakup transactions in which the assets of various businesses of a company like RJR or others are sold to various purchasers, and it simply may be a function of making the pension plans of the various constituent parts fit with one another that lead to the termination of some pension plans and

may not impair radically the long-term benefits provided to the employees of the companies.

I would note in addition that any attempt to deal with this specific problem would raise its own complications. We already have been studying this question and we have recently passed legislation on reversions generally.

I would think that letting that legislation do its work for some period of time and determining whether or not we really do have a problem here is a very important thing to do at this point in time and, as events sort themselves out, continue to monitor the situation to see whether specific action is necessary.

But we would recommend very strongly that no specific action be taken at this time.

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you very much.

[The statement of Mr. Trier follows:]

For Release Upon Delivery
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April 27, 1989

STATEMENT OF
DANA L. TRIER
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am here today at your request to present the Treasury Department's views on the role of qualified pension plans, in particular defined benefit pension plans, in leveraged buyouts (LBOs). The Department believes that it would be premature to change the current law regarding pension plans, particularly with respect to reversions of excess pension plan assets, in response to the LBO phenomenon.

BACKGROUND

The Internal Revenue Code provides rules designed to encourage employers to establish and maintain qualified retirement plans. Under these rules, an employer's contribution to a trust established under a retirement plan is deductible to the employer and is not included in the income of the employee. In addition, income earned by the trust assets is not currently taxable to the trust, the employer or the employees. In the case of a defined benefit pension plan, under which an employee earns credit toward a specific pension benefit, the employer is required to fund the plan under one of various actuarial funding methods in such a manner as to ensure that there are sufficient assets to satisfy pension liabilities under the plan.

If a defined benefit pension plan is terminated, plan assets in the trust must first be applied to satisfy plan liabilities. Upon satisfaction of such liabilities, plan assets remaining in the trust, so-called excess assets, may be distributed to the employer. Any such excess assets recovered by the employer are includible in the employer's income for Federal income tax purposes and are subject to a nondeductible 15% excise tax.

Excess assets may arise upon termination of a defined benefit plan because of changes in interest rates and investment performance and because of the actuarial nature of plan funding. In determining the amount of contributions that may be made to a plan, an actuary makes certain assumptions regarding interest rates, the rate of return on plan investments, salary increases until participants' projected retirements, the rate of employee turnover, the rate of employee mortality, and other factors, any or all of which assumptions may prove to be inaccurate. Furthermore, the funding methods that may be used for budgeting the cost of projected benefits generally require minimum contributions that exceed the accrued benefits under the plan. In sum, when a plan is terminated, excess assets may exist because (1) the actual experience of the plan may be different from the assumptions made by the actuary, (2) the accrued benefits, both fixed and contingent, are less than those projected to be earned upon participants' retirements, and (3) the funding method adopted by the employer generally would have required prefunding of projected benefits.

LBO Structure. The typical LBO involves the acquisition of a public corporation by a small investor group, frequently including the target corporation's management and/or one of the LBO funds that pool capital for this purpose. The investors would ordinarily operate through a shell acquisition corporation, which would either merge with the target or make a tender offer for its stock. In either event, the target shareholders would surrender their equity interests in the target corporation for cash and/or debt of the acquisition corporation.

The equity supplied by the investor group typically represents 15 percent of an LBO's total capitalization. Around 30 percent of an LBO's total capital would be subordinated debt, initially in the form of bridge loans which would later be replaced with so-called "junk bonds." The bridge financing often comes from an investment bank, with the junk bonds purchased by investment partnerships, insurance companies, bank subsidiaries, pension funds, and tax-exempt institutions. The largest part (roughly 55 percent) of the total LBO financing would ordinarily be debt secured by the assets and receivables of the target corporation. This senior debt would typically come from a syndicate of banks, but may to a smaller extent involve insurance companies and specialized limited partnerships.

DISCUSSION

Several concerns have been raised regarding the role of pension plans, particularly pension plans with excess assets, in LBO transactions. These concerns include whether the existence of a pension plan with excess assets makes a company more attractive as a target of an LBO, whether pension plans are more likely to be terminated following a successful LBO, and the use of plans to defend against hostile takeovers (leveraged or otherwise).

Attractiveness of Overfunded Plans to Purchasers. The presence of an overfunded pension plan may make a company more attractive as a target of an LBO. Although the purchase price may reflect the value of the excess assets in the pension plan, the excess assets may be viewed as a ready source of cash that may facilitate the LBO financing. For example, the excess assets may provide a source of funds with which to retire some portion of the short-term bridge loans incurred in the transaction, or as a source of funds with which to service the debt incurred. At the same time, the Treasury Department has no empirical data suggesting that the mere presence of excess assets in a pension plan significantly contributes to the likelihood that a company will be the target of an LBO. Moreover, we would note in this regard that recently enacted legislation imposed an excise tax on asset reversions and additional limits on deductible contributions to pension plans that will have the effect of limiting the amount of excess assets that may accumulate in a pension plan. Thus, if the availability of substantial excess assets does facilitate LBOs, the new limitations may reduce this effect in the future.

Increased Likelihood of Asset Reversions. Concern has been raised whether after a successful LBO it is more likely that overfunded pension plans will be terminated. The basis for this concern is that because of the highly leveraged nature of the transaction, there is an incentive to recover the excess assets from the pension plan to facilitate servicing or retiring the debt. Although the Treasury Department has not compiled any data on this issue, the PBGC has compiled some data, which they will address in their testimony before the subcommittee.

If plan terminations are more frequent in the context of LBOs, much of this activity may well be a result of the highly leveraged structure of the transaction. The excess assets might be used to pay interest on the overall debt incurred in the transaction, or to retire some of the bridge loans. Alternatively, the pension plan, whether or not it has excess assets, might be terminated to reduce future expenses. In some cases, because the purchase price would normally reflect the presence of excess assets, the existence of the excess assets may actually result in additional debt incurred in the LBO to finance the acquisition of the excess assets. In this case, the plan might be terminated to retire the additional debt that was incurred effectively to "acquire" the plan.

In some cases, however, the pension plan might be terminated, or replaced with another type of plan, for reasons not directly related to the leveraged nature of the transaction. Thus, for example, elimination of a pension plan may reflect a different philosophy of the new management toward employee benefit plans; new management might, for example, replace the defined benefit plan with a defined contribution plan to which contributions are contingent on profits. Similarly, if a significant portion of the underlying business of the target company is sold off after the LBO, many of the participants in the pension plan may no longer remain with the company, and the role of the pension plan in the company's overall compensation structure may have changed significantly.

Although there may be some higher likelihood of asset reversions in the context of LBOs, we do not believe that it is appropriate at this time to restrict LBOs or to restrict the ability to recover excess assets as a means of reducing the number of reversions. First, the available data does not suggest that asset reversions happen only or predominately in the context of LBOs, or that LBOs arise only where there are excess pension assets. Second, the number and dollar volume of reversions generally has been falling steadily, and reversions are now occurring at only a fraction of the rate at which they were occurring at their peak in 1985. Accordingly, based on the evidence presently available, we do not believe that current pension policies encourage LBOs or that reversions occur only because of LBOs. Rather, we believe that changing the reversion rules would have little or no significant effect on the course of LBOs in the future, and that restricting LBOs would have little or no significant effect on the number of reversions in the future.

In our view, the tax treatment of excess asset reversions should neither be a significant impediment to LBOs nor a significant incentive toward LBOs and, although the issue is one that Congress and the relevant agencies should continue to monitor, we believe that it would be premature to take additional steps restricting an employers's ability to recover excess assets in response to the LBO phenomenon. The current law treatment of asset reversions attempts to strike a balance among the various goals of pension policy, i.e., to protect employees' retirement income security, to encourage the sound funding of plans, to encourage employers to establish and maintain pension plans for their employees, and to discourage the premature termination of these plans. The ability of employers to terminate their pension plans and recover excess assets, whether in the context of LBOs or other corporate transactions, is part of that balance. In addition, many of the current law rules affecting reversions--the new funding limitations, the excise tax on reversions, the excise tax on nondeductible contributions--were only recently enacted. Finally, the number of reversions has declined significantly, perhaps in response to some of the recent changes.

Defensive Use of Pension Plans. In the context of LBOs, and takeovers generally, it has become common to consider using employee benefit plans to defend against hostile takeovers. Such defensive tactics are of two basic types. One approach involves modifying existing defined benefit plans to eliminate any features of the plans that might be attractive to a hostile purchaser. A second approach involves establishing Employee Stock Ownership Plans (ESOPs) as a means of placing a significant portion of voting stock in the hands of employees who might be less likely to tender their shares to a hostile bidder. Since this ESOP approach does not involve defined benefit pension plans, we will not address it in this testimony.

The defined benefit plan defensive approach most often involves amending a pension plan to adopt so-called "pension parachutes." Pension parachutes may take several forms. For example, the plan may be amended to provide that, in the event of a hostile takeover, additional pension benefits (or retiree medical benefits) are to be provided to plan participants, perhaps to the extent of any excess assets or simply at some fixed level above current benefits. Other potential defensive amendments of this type include provisions that would bar plan amendments without participant approval or bar plan termination altogether following a hostile takeover. As long as such amendments comply with the relevant requirements of ERISA and the Internal Revenue Code, we do not see any tax policy objection to the voluntary provision of additional retirement benefits and rights to employees.

This concludes my prepared remarks. I would be pleased to respond to your questions.

Chairman PICKLE. Now, Dr. Utgoff, you may proceed.

STATEMENT OF KATHLEEN P. UTGOFF, PH.D., EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Ms. UTGOFF. Thank you, Mr. Chairman.

The PBGC insures defined benefit pension plans and it is primarily these pension plans that have become involved in the controversy over mergers, acquisitions and the debt structure of corporations. The enormous amount of capital invested in pension funds and involvement of defined benefit pension plans in LBO's had led to several concerns which you talked about earlier. My testimony will address two specific issues that you have raised.

The first issue is whether surplus pension assets play a role in leveraged buyouts [LBO's]. The PBGC is currently undertaking a comprehensive study of the relationship between pensions, particularly asset reversions, and LBO's. The study matches Department of Labor pension data and PBGC termination data against a list of nearly 300 companies that went through an LBO between 1980 and 1987. The LBO list was compiled by the Securities and Exchange Commission. Before I discuss the substance of the study, I would like to make two points. First, the study does not address the broader relationship between all corporate restructurings and reversions. It only examines the relationship of LBO's and reversions. Second, as you know, there are many definitions of LBO's. Our LBO list consists of companies that were at one time publicly traded and have been taken completely private in the LBO transaction.

The PBGC study hopes to answer the following questions:

Are LBO's more likely to happen to companies with excess assets in their pension plan?

Are reversions more likely to occur when there is an LBO?

Are pension plans more likely to be terminated when a company goes through an LBO?

Are new plans more likely to be defined contribution rather than defined benefit when there is an LBO and a plan termination?

Are reversions an important source of financing for LBO's?

Is PBGC's exposure increased when the pension plan remains intact through the LBO event?

Our study is not yet complete. I do not expect complete results until later this summer. Let me, however, share some preliminary findings from the study with you.

Preliminary results from our study indicate that reversions of excess assets are not a significant source of financing for LBO's. Reversions account for less than 5 percent of total LBO financing. The data also indicate that LBO's are not a principal cause of asset reversions. Less than 5 percent of all asset reversions were associated with the LBO's that occurred from 1980 to 1987. This data is consistent with PBGC's earlier findings from a review just of large termination cases. In only two of the largest 30 reversions was the company involved in an LBO.

Although LBO's do not explain the numbers of reversions that have occurred, our preliminary findings indicate that the probability of a reversion increases when there is an LBO. Reversions were

considerably more likely to occur in companies that were involved in an LBO when compared to similar companies that were not. In our sample of 284 LBO's, 54 of the firms had reversions. This compares to 12 firms that took reversions in our control sample of 223 firms.

When a reversion does follow an LBO, the post-LBO pension plan is just as likely to be a defined benefit plan as it is following any reversion. This preliminary finding means that LBO reversions do not affect workers' pension benefits differently than any reversion in general.

The information we have gathered thus far points to the conclusion that LBO's and reversions are related, but they are really separable issues. LBO's are not a principal cause of reversions. But companies that have been through LBO's are more likely to utilize excess assets than other companies, possibly to pay down or to service the debt. As a result, while concerns have been raised regarding the relationship between reversions and LBO's, it is important to note that because LBO's do not account for many reversions, restrictions on LBO's won't stop reversions. Similarly, because reversions do not provide a major source of capital for LBO's, restrictions on reversions won't stop LBO's.

The issue I am most concerned with is the effect of LBO's on companies that sponsor pension plans and the potential risks LBO's pose for the PBGC. Although I hope our study provides systematic evidence that sheds some light on my concerns, there are already good reasons for PBGC to closely monitor the effects of LBO's on pension plans. LBO's may pose threats to pension plans and the PBGC because they may increase the probability that more firms will encounter financial difficulty, reduce the funding of the pension plans and reorder the claims of the retirees and the PBGC versus shareholders.

Claims against the PBGC come from companies in severe financial distress. Financial distress can lead to reduced funding of the pension plans and to bankruptcy. Greater leveraging could pose problems for the PBGC if it increases the chances of financial distress for companies that sponsor PBGC-insured pensions.

If highly leveraged companies are more likely to fail, then the PBGC will be asked to step in more frequently if LBO's increase. The cost to the insurance program of those failures will depend on the funding of the pension plans and how much of any underfunding the PBGC can recover when it is a creditor in bankruptcy. Companies with high debt costs are more likely to fund pension plans at minimum levels required by law and are more likely to apply for waivers of pension contributions. In addition, the distribution of assets to the shareholders in an LBO reduces the assets available to the PBGC as an unsecured creditor in the event of a bankruptcy. The net result is that even if LBO's do not increase the probability that a company may fail, each failure when there has been an LBO will be more expensive for the PBGC.

Let me discuss a case at the PBGC which illustrates our concern.

Kaiser Steel was involved in an LBO in 1984. Nearly $200 million was distributed to shareholders and other parties involved in the restructuring. In 1987, Kaiser filed for bankruptcy and the PBGC was forced to take over the pension plans that were under-

funded by $200 million. The recoveries we can count on in this case are minimal—a portion of the reorganized company's stock and $1 million in cash. Kaiser simply had no assets to satisfy the claims of unsecured creditors. The PBGC was not the only loser in this case. Retirees had claims for health care promised by the company that were worth several hundred million dollars. Retirees' recoveries on these claims were less than $10 million.

This case is not over. Lawsuits have been filed against virtually all the participants in the 1984 LBO. The retirees and the PBGC may recover something from the lawsuits but recovery amounts are speculative.

Kaiser is a good example of the complexities of this problem. The LBO was certainly not Kaiser's only problem. Kaiser's steel business had already been shut down before the LBO. The problems of the steel industry are well known and the PBGC may have been forced to pay for Kaiser's pension in any event. Whether or not that is the case, the assets available to cover the pension underfunding would have been greater without the LBO, and that is the important point.

The effect of the Kaiser LBO was to reorder the priority of different claims against Kaiser's assets. Shareholders, usually the lowest priority creditor in bankruptcy, profited, as they often do in an LBO. The distribution of cash to shareholders reduced the assets available to satisfy the claims of creditors. The effect of an LBO on the rights of different claimants has been the source of complaints from bondholders of bonds that were issued before an LBO. Bondholders are now beginning to put covenants in their agreements to protect their rights, and that is a normal market response. The PBGC and retirees do not have the same opportunities.

In this respect, the LBO transaction is not unique. A variety of corporate restructurings, sales and bankruptcies pose the same problems for the PBGC. These transactions can result in new debt added to an already troubled company's books that has a higher priority than the existing pension obligation and retiree claims.

Let me make it clear that my concerns about the possible effects of LBO's on the government pension insurance system are not a criticism of LBO's. There is evidence to support the belief that LBO's increase the efficiency and value of a company and that pension plans can benefit from that increase in value. But every party with a stake in a firm does not share equally in the risks and benefits of an LBO. The PBGC and other unsecured creditors, for example retirees with unfunded health benefits, may take risks without a proportionate share in the gains.

This does not mean that LBO's have to be restricted to protect the PBGC or retiree benefits. We can explore other solutions to make sure that the legitimate rights of all parties that have a stake in a firm are not jeopardized by new and perhaps very useful corporate financing techniques.

Thank you very much.

Chairman PICKLE. Thank you, Dr. Utgoff.

Now, I have several questions—and let me just say, Dr. Utgoff, when you say there is evidence to show that these LBO's increase the value of a company and pension assets, you mean sometimes it does; not always?

Ms. UTGOFF. That is right.

Chairman PICKLE. But there is some evidence to that effect.

Now, let's see, we have questions for each one of you, and I guess I will start off with Mr. Walker.

First, with respect to asset reversions. We have a lot of controversy about this. Neither side has agreed on a proper approach or even on the principle involved. We are trying to find out what really happens to a worker when one of these terminations does take place.

My question is, In those instances where a defined benefit pension plan is terminated following an LBO, and where there is either no successor plan or where a successor plan does not grant past service credits to long-term workers, what is the impact on the pension income for those workers?

Mr. WALKER. Well, the impact essentially would be the same as it would be if there was not a leveraged buyout or a change in control. When you have a plan termination where there are residual assets left after termination, several conditions have to be met before those residual assets can revert to the employer.

First, all plan participants must be fully vested in their accrued benefits.

Second, annuity contracts must be purchased to secure the value of those accrued benefits on a prospective basis.

Third, to the extent that there were any employee contributions, to the extent that they had contributed part of the funds that had gone into the pension plan, their benefits would have to be raised to recognize the fact that part of the investment returns were attributable to employee contributions and they should share in that.

The bottom line is that participants are fully protected with regard to their accrued benefits when there is a termination.

Chairman PICKLE. You mean, I take it, though, they are as fully protected under an LBO takeover as they are under a regular termination?

Mr. WALKER. Right.

Chairman PICKLE. That is the point I am trying to get at. It would seem to me whether you have an LBO or a regular termination, the question that is legitimately raised is what happens to the worker's benefits?

As I recall it, the worker gets the best of what, say for example, the top 3 years, times the number of years?

Mr. WALKER. That is correct in some types of plans.

Chairman PICKLE. So in a termination that worker could end up with about 50 percent less in pension assets; is that correct?

Mr. WALKER. You are talking about what happens after the termination with regard to the value of future benefits; is that correct?

Chairman PICKLE. Yes.

Mr. WALKER. The answer to that question depends upon whether or not a plan is re-established and the type of plan that is re-established and the benefit formula under that plan.

The statistic that you were quoting, can be misleading. Specifically several years ago the department's then chief economist conducted a study that showed that participants could lose up to 45

percent of their future benefits if a pension plan terminated and there was no new plan.

Chairman PICKLE. And it is that point that I want to more or less keep in mind as we look at this overall problem about LBO's and terminations.

What really happens to a worker's benefit, and, if he loses between 45 and 50 percent, that ought to pose a serious question for this Congress.

What do we do about that?

Mr. WALKER. Congressman, let me make two points there.

First, you have the issue of terminations involving asset reversions. And what, if anything, ought to be done about that issue standing alone?

Second, we have the issue of leveraged buyouts, and corporate takeovers. And there could be a correlation between the two. I think it is very important that the PBGC study be completed to try to analyze to what extent is there an increased correlation between, when you have an LBO, does that result in a higher probability that there will be a termination with a reversion?

What are the characteristics of successor plans? Are they more likely not to have a plan or a different plan? My understanding is that based upon the preliminary results of PBGC's study, there doesn't appear to be a significant difference between the kinds of successor plans that are created when a LBP is involved.

So I think it is important that we look at them that way.

Chairman PICKLE. It is good to look at the whole picture. But I say that the bottom line also, the basic question is, What really happens to the worker's benefits when there is a termination on either a regular basis or an LBO?

I am afraid that the worker does probably lose up to 45 percent of his benefit. Now if that is so, that point should be kept in mind.

Let me go on now. I have a lot of questions for all of you here. Now, we know that the pension investments are small, but that doesn't mean, though, that every individual plan has taken a very conservative approach.

My question to you is, How does your department, Mr. Walker, monitor the level of investment of the individual pension plans in an LBO-related investment? What steps would the department take if it determined that a plan had invested too heavily in this area?

Mr. WALKER. The basic source of information that the department uses for enforcement purposes is Form 5500. It is the annual report form that all pension plans must file. That form was recently revised. It has certain data in it that could be helpful to us.

For example, it has a list of assets, the nature of those assets. It also requires a pension plan to be able to note any particular investment transactions that involve more than 5 percent of the plan's assets.

So we do have information that we gain through the annual report form that has to be filed every year.

Chairman PICKLE. Do you have any specific example of where a company has invested too heavily in this particular area?

Mr. WALKER. Mr. Chairman, we are not aware of any plan——

Chairman PICKLE. Now you have made some changes in your 5500. Do you think that the plan that the changes that you made would address this question about whether somebody has overly invested?

Mr. WALKER. The new form is better than the prior form, and I will say that we are currently reviewing the current form to consider whether or not any additional changes should be made in order to focus on this area.

The form will have to be revised for next year primarily because of the extensive changes mandated by the Tax Reform Act.

Chairman PICKLE. I would hope that you would let us have the benefit of what you are thinking about. What would you, the Department of Labor, consider to be an excessive level of participation by a single plan?

Mr. WALKER. I think what we may want to do, Mr. Chairman, is to determine whether or not we need to capture more precise data with regard to the extent of a pension plan's investment in high-yield bonds or leveraged buyout funds.

It is very difficult to say that 10 percent or 15 percent or at 5 percent is too much. But I do think we want to make sure that we have adequate data to know the nature and extent of those investments in order to make judgments as to whether or not we should take action.

Chairman PICKLE. Let me yield to Mr. McGrath. I have questions for Treasury, also.

Mr. MCGRATH. Thank you, Mr. Chairman.

Let me touch on a subject which is one of controversy. What is a junk bond? High-yield bonds or junk bonds generally are described as not being investment-grade securities.

Let me ask you a hypothetical question. Would not any pension plan investment in junk bonds be a violation of a manager's fiduciary duty under those circumstances?

Mr. WALKER. It would not be a per se violation of ERISA. What ERISA would require a pension plan fiduciary to do is, in making such investment decision to invest in high yield, so-called high bonds, to be able to ascertain that, No. 1, that based upon the plan's other investments and needs, that it is meeting the diversification requirements of ERISA and that it would be a prudent investment for the plan.

A real consideration there would be to make sure that the plan is getting an appropriate rate of return, given the level of risk it is assuming, including any reduced liquidity. There are certain other types of, quote, unquote, "higher risk investments" that may not have a taint associated with them, such as venture capital, certain forms of real estate investments, et cetera.

And the way the rules work under ERISA, it gives a fairly great degree of discretion to fiduciaries provided that they meet the diversification requirements and provided that they are getting the appropriate rate of return given the risk involved and in light of the plan's needs.

Mr. MCGRATH. My own view is that some of these so-called junk bonds are not so junky.

Let me ask you this question: Has the net result of LBO activities either been to increase or decrease the number of workers covered by defined benefit pension plans?

Mr. WALKER. Kathy, has your study addressed that at all?

Ms. UTGOFF. No, we have not gotten to that point yet. We are looking at related statistics.

Mr. MCGRATH. What is the extent to which public and State government pension plans play a role in LBO's? Do we have any information on just how many State government pension plans or local pension plans are active in this kind of activity?

Mr. WALKER. We do have data on the extent of State and local plan involvement, but it is somewhat sketchy because State and local plans are not subject to ERISA and, therefore, they do not have to report to the Federal Government or in some cases even to their plan participants and beneficiaries.

Based upon data that we have been able to get through Wall Street and various providers, most of the activity by pension plans in junk bond investments and in LBO-funded investments has been on behalf of public pension funds that are not subject to ERISA.

They have tended to be more aggressive in this area than private pension funds have. For example, I believe my testimony shows that two-thirds of pension plan investments in LBO funds are attributable to public pension plan funds and over half of pension plan investments in so-called junk bonds or high yield, higher risk bonds are by public pension funds.

Mr. MCGRATH. We have no real way, because there is no real report required other than the end-of-year reports on their activities?

Mr. WALKER. That is correct. They are not subject to ERISA and therefore not subject to the reporting fiduciary or other requirements of title I.

Mr. MCGRATH. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Let me ask any of the panel, if I might, what has changed the marketability of junk bonds with respect to pension funds? Junk bonds or high-yield bonds or noninvestment bonds have been with us for many decades, they are not new.

Only in the last 8 or 10 years, however, have they found the kind of a market that is a wide and vibrant market and allows people to accumulate substantial amounts of cash by junk bonds.

What has persuaded pension fund managers to purchase junk bonds now when they largely wouldn't or didn't 15 or 25 years ago?

Mr. WALKER. I think there are probably several things, and I will ask my colleagues to add on this.

First, the size of pension holdings has increased significantly over the last 10 years. They are major investors in corporate equities, corporate debt, and they therefore have a growing need to diversify into other areas.

Secondly, most pension plans are also very well funded. They are funded on a termination basis very well, and that has improved significantly over the last 10 years. That has affected their outlook, I think, as to how much risk they might be able to take.

Thirdly, I think that in looking at the performance of so-called junk bonds over the last 10 years or so, I think that they have performed fairly well.

Now, as I mentioned in my testimony, they have not been tested by full market cycle, and that is something that I think we want to keep in mind. But they have performed well.

The default rate has been lower than many people would have anticipated and, therefore, some of the initial concern that might have been concerned about it on behalf of fiduciaries has been reduced.

Mr. DORGAN. Do you mean that junk bonds that call for deferred interest payments have not missed——

Mr. WALKER. I am not saying that none have. I am saying that statistics have shown that they have performed in the aggregate well. In fact, many times when pension plans invest in so-called high-yield bonds, they do it through a pooled arrangement such that, in effect, they have two degrees of diversification.

One degree is that they are invested in equities and corporate debt and government securities, et cetera, and only a small percentage is in so-called high-yield bonds.

Another degree of diversification is that they don't put all of their eggs in one particular issue. They invest in a pool portfolio of bonds.

Mr. TRIER. The junk bond market has grown radically and investors of all kinds have increased their investments in junk bonds over that same period of time. That may partly be due to the good results of the economy in the last few years, but it may be that more information is available.

They have been discovered. There is a whole informational network involved with respect to junk bonds. And pension plans are just one institution that has gone along with other institutions in that respect.

Life insurance companies and others have also invested in junk bonds to an increasing extent. I think we all remain a little puzzled, you know, as we address the LBO phenomenon generally with what exactly has led to this increase.

I don't think that there is any great data.

Ms. UTGOFF. When you talk about junk bonds, there are those associated with LBOs and then there are just other bonds. Below-investment-grade bonds have been around for a long time for troubled companies.

And so when you are talking about pension plans getting involved in this new class of junk bonds associated with LBO's, these are really not all of junk bonds, and it really is a relatively recent phenomenon.

When pension plans may have steered away from the normal, below-investment-grade bonds, the advent of the LBO provides really a different investment vehicle that could be pooled and has different risk characteristics than the normal junk bond.

Mr. WALKER. I think an important point here, Congressman, is that according to a recent GAO study, less than 50 percent of the high yield so-called junk bonds are related to takeovers and leveraged buyouts. They might want to corroborate that. So they are not all associated with changes in corporate control.

Mr. DORGAN. A substantial majority of them are, at least as I understand it. We can get some numbers.

Let me make one more observation. Peter Drucker, in some of his writings, suggests that the growth of the demand, or the market for junk bonds—incidentally, the reason I raise the question of junk bonds is that I think junk bonds are the engine that allows LBO's to occur. Without them, the whole bubble largely bursts, and dissipates.

Drucker says that because you have to define benefit pension plans a couple of decades ago there is enormous pressure on all fund managers to do better than average in order to decrease the corporate contribution that is necessary. And because the system really means that everybody will come out about average, everybody who is running a fund trys to beat that system by looking for increasingly risky investments, going particularly to high yield bonds or junk bonds. That is what has created the market. That is Peter Drucker's notion.

I don't know if that is accurate. I have not pursued that line of reasoning. Any observations about that?

Mr. WALKER. My experience has been that pension plan portfolios have a lower general level of risk as compared to other types of institutional investors and other non-ERISA investors. In fact, with regard to LBO funds and junk bonds, less than 15 percent of all the junk bonds that have been issued, whether or not they are associated with changes of corporate control, and less than 15 percent of the assets in leveraged buyout funds are attributable to pension plans, and most of those are attributable to public pension plans and not private plans.

So I wouldn't share that view, even though I have great respect for Peter Drucker.

Mr. DORGAN. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Anthony.

Mr. ANTHONY. Mr. Walker, would you give a little bit more detail on the answer you just gave to Mr. Dorgan? Because I think it may feed into a question that I wanted to ask, because I am not sure I really comprehended the numbers that you were tossing about.

The area that I would like to discuss is the purchase of participation in a blind pool by a pension fund manager and how that operates, how much information they have, if there is a floor, how much information they have in terms of what they are going to be buying, what costs are going to be standing behind the bonds.

You mentioned something about 15 percent——

Mr. WALKER. Right. I assume you are talking about the LBO limited partnership funds, or whatever the plans might invest with?

Mr. ANTHONY. Yes. And keep in mind what I am trying to ascertain is what is the standard for a prudent manager in terms of how much knowledge should he have when he invests this money? I am trying to figure out how he knows, how much he has got to invest before he is able to look and see what backs up his investment?

Mr. WALKER. I would say that is an excellent question, and probably one of the more insightful questions on this issue that I have heard in a while. The issue here is investments in these limited partnership funds. The statistic that I quoted before is that based

upon available data, less than 15 percent of the capital that has been committed to LBO limited partnership funds—which is what you are talking about—relate to pension funds.

Of that 15 percent, a majority relates to public pension fund, State and local pension funds. So, therefore, you are talking about less than seven and a half percent relating to private pension plans. Therefore, I think you can say that private pension plans aren't driving these funds. If private pension funds weren't investing in these funds, they would still exist.

Now, with regard to your question, typically what will happen——

Mr. ANTHONY. Would you back up and quickly tell me where the other 85 percent is coming from? Is it coming from a multitude of investors that are pooling their money in these limited partnerships?

Mr. WALKER. Yes. Some of which are tax exempt, some of which are endowment funds, and other nontaxable and taxable entities. With regard to these LBO limited partnerships, for example, the KKR Fund, that related to the takeover of RJR Nabisco, typically the way these things work is they will obtain commitments from investors and they won't necessarily actually take the funds until they have a deal. After they have a specific deal, they want to do and, therefore, will obtain funds based on those commitments.

Mr. ANTHONY. Am I committed, if I tell you that I am going to put up whatever the required amount—is there a required amount? Is there a floor amount, a minimum?

Mr. WALKER. Candidly, I would have to look into more detail to give you an answer to that question as to exactly what the legal obligations are once a commitment is made. If I get the thrust of your question, it is to the extent that a pension plan is making a commitment to invest in an LBO limited partnership, how much information should they have, and must they have before making that commitment, if they don't know what the transaction is going to look like?

Mr. ANTHONY. I must admit, before you answered Mr. Dorgan's question, maybe my concern was not as great, but when you are now telling me that of the 15 percent, the greatest number is coming from the public sector, I must tell you that the import of my question is even raised higher in my own eyes, because I don't see a great deal of expertise in the public sector as compared with the private sector in terms of analyzing these arrangements. I find in too many cases the public sector is dependent upon the private sector for its advice and consultation in terms of where those funds should be directed.

So, now that you have given me this information, I am even more curious as to how much information is required in order for that person to meet the prudent test?

Mr. WALKER. I would like to be able to provide for the record, Mr. Anthony, if it is acceptable to you, I will try to provide information on how these normally work, and what type of information would be available to the plan. We can go from there, if that is acceptable.

Mr. ANTHONY. That would be fine.

[The information is on p. 41.]

Mr. ANTHONY. With that, I yield back my time.

Chairman PICKLE. I think the fact is you have no measurement how much investment in junk bonds is too much. You just don't have a measurement, do you?

Mr. WALKER. There is not a hard and fast number, nor is it necessary that there should be one. I can tell you this, that we are not aware of any plan that holds a significant percent of its assets in the form of both of these types of investments combined. They would be less than 10 percent of their assets—in most cases much less than that—in both of these types of investments combined.

That fact when combined with the fact most pension funds are very well funded, further lowers the degree of risk to the security of private pension benefits.

Chairman PICKLE. Those LBO funds are growing and it is going to be a problem, and we better start addressing them.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

This follows along the same line of questioning. First, I would like to thank the panel for their testimony. It is very interesting. My question is, How are pension managers generally compensated?

Is there an incentive for them to make riskier and/or better yielding investments? Do they get bonuses or commissions, or are they paid a flat rate whether they are successful or not?

Mr. WALKER. Investment managers are typically compensated based upon a percentage of the assets under management. A typical number would be 150 basis points per year for the amount of assets that they have under management. Therefore, their compensation would vary based upon whether or not the portfolio that they are managing goes up or goes down. But it isn't highly leveraged. The formula isn't leveraged.

There has, however, been an increasing interest on behalf of pension funds to try to move toward more performance based fees—incentive compensation, if you will—to try to assure that they are getting value added from investment managers, that they are not just merely matching the market or they are not merely matching what a normalized portfolio would say they should get, that they are doing something better than that.

If the manager does better than the predetermined benchmark performance they get more money, adding some leverage to the transaction. But a vast majority of investment managers at the present time are compensated based on a fixed percentage of assets under management. A typical percentage would be 150 base points.

Mr. SCHULZE. So under either of those methods of compensation there is a built-in bias to try to increase the resources and increase the income as much as possible because it will increase their compensation?

Mr. WALKER. Well, investment managers are provided investment guidelines by the plan, by the named fiduciary. The investment guidelines typically will provide a framework which the investment manager must comply with. Quite frequently, those investment guidelines will have guidance as to the degree of risk, the degree of liquidity that the plan is looking for, and as I am sure you can appreciate, any time you have an increased degree of risk, you also have an increased possibility of loss.

To the extent that the investment manager doesn't perform, they can end up losing the account in its entirety. So there are checks and balances involved and there are constraints and pressures that would keep them from taking too much risk.

One of the most significant constraints is ERISA, and the prudent man rule, and the fact they are personally liable if they violate the law.

Mr. SCHULZE. Dr. Utgoff, did you want to add anything?

Ms. UTGOFF. Well, I think maybe we ought to focus on the larger picture here. I think there is a significant question as to why pension plan managers take the low risk levels that they do. On average the risk measures of investments in pensions are lower than the market as a whole.

When you talk about a money manager being compensated on the basis of what he chooses, in most pension plans there are specific managers for junk bond portfolios and for regular bond portfolios. A manager doesn't say, I am going to take the money out of my junk bonds and put it into something else. It is the person who is the trustee of the overall fund that makes those decisions, and you have to be careful to understand how these things work and to realize that there is really no belief that, overall, pension plan managers are taking a great deal of risk.

The PBGC takes over a hundred pension plans a year because they fail. Never once has that failure occurred because there has been overly risky investment. Pension plans fail because the companies that sponsor them get into trouble. There is no evidence that pension plans are taking on too much risk. In fact, there is evidence that they have a lower threshold of risk than the average investor in the market.

Mr. SCHULZE. Along that line, is there any evidence that LBO activities have caused companies to terminate prematurely their pension plans in order to reclaim excess assets?

Ms. UTGOFF. There is evidence that if there has been an LBO, there is more likely to be an asset reversion following the LBO than for a similarly situated company that has not had the LBO.

Mr. SCHULZE. It could follow logically if a smaller company is acquired by a larger company. It would seem to be a natural transaction to fold that pension plan in and actually at times the employee would be a little bit better off by being part of the larger operation.

On how many occasions would you say that happens? Half of the time or three quarters of the time? There probably are no statistics, so it has to be a guess.

Ms. UTGOFF. The GAO will present statistics on that later, but frequently when there is an LBO—and we are going to continue to do research on this—and there is a defined benefit pension plan that is over-funded, that pension plan will be terminated.

But frequently, the pension plan will be replaced by another one, so that the transaction has no effect on the pension benefits available to the workers. It is simply a transaction to use money for other purposes.

There are two basic separable transactions here. One is a plan termination and the other is a scheme to recover excess assets from

a pension plan without changing the employer's overall employee benefit program.

Mr. SCHULZE. I believe that those who see evil in this would say when this happens, the plan is terminated and the worker is left out in the cold. Are there statistics showing how many companies went out of business within 12 months of an LBO, which might bear out their doom and gloom forecast?

Mr. WALKER. I am not aware of those statistics at the present point in time, but the PBGC is conducting its study on the degree of correlation between terminations involving asset reversions and LBO's. We at the Labor Department intend to conduct some additional studies going beyond that, first to look at possibilities of terminations occurring before the LBO occurs, and secondly, to broaden it to look at takeovers where one public company is taking over another public company, either termination reversions after the transaction, or once a company is in play. Once somebody has taken a significant enough position there may be concern they may be taken over, and therefore, we want to look at the actions that might be taken to defend against that takeover.

Mr. SCHULZE. Are there any general statements that we could make about the employees of acquired companies? Can we say generally the employees in an acquired company are better off, worse off, or the same. Or is it difficult to make that kind of evaluation?

Ms. UTGOFF. Well, we are talking—I can talk a little bit about the pension arrangement. When there is a leveraged buyout and there is asset reversion——

Mr. SCHULZE. I am talking about the narrow confine of pensions.

Ms. UTGOFF. An LBO is not any different when considering the terms of a subsequent pension arrangement than any other asset reversion. So if you are looking at the impact on employees, you want to focus really on asset reversions and plan terminations rather than LBO's.

If your focus is pension rights, then it doesn't appear that leveraged buyout affects those pension rights any differently than any other asset reversion. Leveraged buyout is not a significant factor in that.

Mr. SCHULZE. Is there a difference in the pensions of nonprofit employers versus for profit employer pensions? In other words, do section 501's structure their pensions differently than a for profit company?

Ms. UTGOFF. There are two different kinds of pension plans. One is a defined benefit pension plan; the other is a defined contribution plan that has different characteristics because it has individual accounts for each participant. In general, I think going back to your earlier question, individuals tend to choose specific types of investments that are different from those chosen for pooled trust funds, as you would expect, because they have lower risk thresholds.

Mr. SCHULZE. What I am referring to are 501 (c)(3), (c)(4), and (c)(5) organizations, and so forth. Do they look at pension plans differently because they don't have to worry about a tax deduction. I believe they are under ERISA, aren't they? Is there a different outlook?

Mr. WALKER. Clearly to the extent that you have a plan that is not a qualified plan or based upon the nature of the plan's investments its earnings may be subject to taxation, that would have an effect on their investment behavior because they are basically looking to try to achieve a positive net economic return to the plan, given the level of risk.

Most of the plans that we are talking about and relate to the data that we have provided, 99 percent plus involve qualified plans, and tax exempt entities, where the earnings of the trust are not subject to taxation.

Mr. SCHULZE. We are talking about the pension plan itself, not the company that is a tax exempt entity?

Mr. WALKER. Correct. The corporation can take a deductible contribution. The earnings grow tax free.

Mr. SCHULZE. Does the national YMCA look at their pension plan differently than General Motors?

Ms. UTGOFF. One of the interesting things that we have noted is that publicity on asset reversions seems to be focused on company greed, but there have been a number of asset reversions by companies that don't pay taxes. What they simply find is, because of a number of factors, they ended up with too much money in the pension plan.

That is why this area is so complicated. There are a variety of circumstances and a variety of reasons why companies have said, "We need to engage in a termination reestablishment of a pension plan that gives us access to excess assets."

Mr. SCHULZE. Have there been any of those in the section 501 nonprofit community?

Ms. UTGOFF. I would have to get back to you on that.

Mr. WALKER. 501(c)(3)'s generally do have qualified plans and generally there won't be any differential between how they would invest, because they are subject to the same tax treatment.

Mr. SCHULZE. Their attitude toward that pension plan would be the same as anybody else?

Mr. WALKER. In the pension plan, but there is a difference that Dr. Utgoff mentioned, and that is, to the extent they might terminate the plan for a reversion, they don't have to be concerned as much about the tax consequences of that, and therefore, they are more likely to do it for other reasons. They are more likely to do it for legitimate business reasons.

Mr. SCHULZE. Thank you.

Thank you, Mr. Chairman.

Chairman PICKLE. Well, thank you.

Now, let me ask Treasury some questions here.

Mr. Trier, does Treasury have any position on whether banks or pension funds or others should be investing in junk bonds?

Mr. TRIER. I think to the extent we had a position, I think it is that it really depends on what the nature of the investor is. When we are talking about pension fund investments and junk bonds, my own view would be even though it is really not within Treasury's province, that David Walker's testimony is essentially correct.

Chairman PICKLE. I am just trying——

Mr. TRIER. Our policy may be different towards banks, for example. We may think because of the special treatment of banks and

because they are insured entities, and they don't have the downside risk of their investments going wrong—although it is not my job, but they may have a different view of that.

Chairman PICKLE. Mr. Trier, you say Treasury may have a different policy with respect to banks. My question is, Do you have any policy about the investments with respect to banks?

Mr. TRIER. Not that I know of.

Chairman PICKLE. Do you agree—Treasury—that these junk bonds are risky bonds?

Mr. TRIER. I think they vary depending upon the bond—and I do think that perhaps the word "junk", as Congressman McGrath alluded to earlier, overstates how junky some of the bonds are—but I think they are more risky than the normal investment.

Chairman PICKLE. Everybody says, and it seems to me there is general agreement, that junk bonds are risky bonds, at least if you take them on what we call a credited bond—there is a AAAA, AAA, AA, and A, and then there is B, and C, classification of junk bonds.

So, Mr. Trier, you have to say in the overall jargon of investment, junk bonds are very risky bonds, are they not?

Mr. TRIER. Yes, they have more risk.

Chairman PICKLE. Then do you have any kind of mesurement—Treasury—about what is prudent investment by fiduciaries, if he makes an investment in these bonds?

Mr. TRIER. Because that is generally within the Department of Labor's province, we do not have an overall position.

Chairman PICKLE. Do you have any specific instances where the pension plans have invested excessively in junk bonds?

Mr. TRIER. We are aware of none.

Chairman PICKLE. One more question for my general information. We know that less than 1 percent of the pension funds assets are invested in junk bonds—1 percent or 2 percent, whatever that is. Would this percentage be larger if indirect investment in junk bonds through ownership of mutual funds were included in the measurement?

Mr. TRIER. I don't know the answer to that.

Mr. WALKER. The statistics that I provided, Mr. Chairman, with regard to junk bonds, which said that less than 2½ percent were invested in junk bonds, were intended to address both direct and indirect investments. I will have to check with regard to mutual funds.

I will tell you this. My statistics definitely included insured plans and, therefore, to the extent insurance companies are investing in junk bonds, allocating a portion of their general reserves back.

[The information of Mr. Walker is on p. 41.]

Chairman PICKLE. Mr. Walker and Mr. Trier, I would say to both of you this subcommittee would like to know specifically how much money is actually being invested through indirect ownership. I have a feeling if we just open that door a little bit you are going to find it is a higher percentage than you think, but we need to know that.

Mr. DORGAN. Will the chairman yield on that point.

Chairman PICKLE. Mr. Dorgan.

Mr. DORGAN. We had similar responses from the savings and loan side of this issue by the Federal Home Loan Bank Board. The assurances were, that, when you take a look at the aggregate you are not talking about any significant investment. So I asked for a copy of information that would tell me what the 10 largest savings and loans holding junk bonds in the country are.

They sent them to me and asked that I not make them public because of the sensitivity. I was interested to find that there is one savings and loan that has 34 percent of its assets in junk bonds. Now, maybe in the aggregate that is not a big problem, but with respect to that institution, that concerns me.

The question the chairman was asking you was, Are you aware of any pension funds that have invested so heavily it would cause you concern?

Your answer was no, you weren't aware of any. I guess I question if you have no standards, which was the answer you propounded previously to that, you don't have any standards by which to measure that. If you have no standards, and aren't looking, why would you expect to be aware of it?

Mr. TRIER. I think the dispersion is very important. I think it is very important to understand.

Mr. DORGAN. To get to what the chairman was trying to ask, if you have got a pension fund out there that because it is part of the golden circle of friends, you know, I am talking about——

Mr. TRIER. Beverly Hills.

Mr. DORGAN. The people who make a half a billion dollars a year and all of a sudden this pension manager gets real enthused about junk bonds and with a couple of phone calls place substantial junk bonds in the portfolio of that pension fund, would you necessarily know that, or would you be looking for it? Would you have standards that determine whether you should be concerned at a certain level?

If 10 percent or 25 percent or 40 percent of assets of a particular plan were placed in junk bonds, would that represent a concern to you?

Mr. WALKER. If I can, the Department of Labor handled the fiduciary requirements which really is ~~the~~ issue here. We are not aware of any plan that has more than 10 percent of its assets invested in these types of investments.

Mr. DORGAN. Are you looking?

Mr. WALKER. We are trying to monitor, yes, to the extent that we have information available, and in addition to that, we are looking at possible revisions in the annual reporting form requirements to assure that we will have adequate information in the future to stay on top of it as pension plan investments grow.

Mr. DORGAN. The important question the chairman is propounding is would you be aware of it if it now exists? The fact you are not aware of it is something I understand. If it exists today that some pension fund out there has 25 to 30 percent of their assets in junk bonds, because they get a couple calls and Milken decides to buy a bunch of junk bonds, would you be aware of that necessarily?

Mr. WALKER. We would not be aware on as timely basis as we would both want.

Mr. DORGAN. The followup question is, should you be aware of it?

Mr. WALKER. The answer to that question is that we are looking at possibly revising the reporting requirements in order to assure that we can.

Mr. DORGAN. The answer is yes, you should be aware of it and you are trying to develop a mechanism that allows you to get to that point?

Mr. WALKER. Right, but there is also a question as to the burdens involved, what the reporting burden and the cost/benefit are, but yes, this is an issue we care about and are looking at.

Mr. DORGAN. Mr. Chairman, I have one more observation. I appreciate your patience. The explosion of the market for junk bonds, and the answer to the previous question that I asked about the market is if Milken provided liquidity, which then made the investment attractive, the explosion of that market was accomplished in part because pension funds were willing to invest in those kinds of assets.

It seems to me that when this began to explode, the increase was exponential year after year, and that some place somewhere somebody ought to be concerned about individual plans and how heavily they are investing in these more risky bonds.

I guess your answer is clear, but we need to get to the point where we understand, if there are problem areas out there. Then, what guidelines do we use to measure that, and what steps do we take to deal with it?

Thank you, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Dorgan. I will repeat again to you in my own instance, I have talked to people who have been engaged in these LBO's where they have not used junk bonds, and I have been advised that a greatly increased practice these days is for indirect investments to be made through Merrill Lynch, Paine Webber and so forth, and that if that is so, we need to know it.

So, we are going to ask you to give us something specific on that. We are concerned about it, not just aware of it, but we are concerned about it. Submit that to us.

[The information follows:]

U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210

August 9, 1989

RECEIVED
AUG [illegible] 1989
Ways and Means
Subcommittee on Oversight

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
1105 Longworth House Office Building
Washington, DC 20515

Dear Congressman Pickle:

On April 27, 1989, your Subcommittee held hearings regarding leveraged buyouts and the role of pension funds. David M. Walker, then Assistant Secretary of Labor for Pension and Welfare Benefits, agreed to provide information regarding the relation of pension plan terminations to corporate control contests. He also agreed to address the nature and extent of pension plan investments in LBO pools.

The results of a recent analysis of the relation of plan terminations to changes in or restrictions of corporate control are reported in Attachment A to this letter. The study focused on takeovers, takeover threats, and management or leveraged buyouts.

Briefly, this analysis shows that, between 1980 and 1987, 12 percent of plan terminations with a reversion of $1.0 million or more occurred within one year following a corporate takeover. We do not know the extent to which the primary purpose of these terminations is to strip plans of their excess assets or merely to integrate the workers in the acquired firms into the pension plans of the new parent corporation. Nonetheless, the terminations do result in reversions and they do follow hard upon a corporate acquisition.

In addition to termination/reversions following takeovers, an additional 16 percent of terminations with a reversion of $1.0 million or more may be related to corporate control contests even if a takeover does not actually occur. The analysis in Attachment A indicates that 11 percent of termination reversions between 1980 and 1987 occurred either within one year prior to a successful takeover or one year after an unsuccessful takeover attempt.

Finally, the analysis in Attachment A indicates that 5 percent of termination/reversions between 1980 and 1987 occurred within one year of a management or leveraged buyout.

Although the results in Attachment A must be viewed with caution, it does appear that as many as 1 out of 4 terminations with reversions of $1.0 million or more may be related either directly

or indirectly to corporate takeovers or efforts of management to retain corporate control. PWBA has contracted for a more comprehensive study of the relation between corporate control activity and plan terminations. PWBA research staff are currently reviewing the preliminary results of this study, and a final report is expected in late September.

At the April 27 hearings, Mr. Walker also agreed to study two aspects of pension plan investments in LBO pools. You were concerned with the extent to which private pension fund investments facilitated LBO activity directly via commitments to LBO financial partnerships and indirectly via investments in "junk bond" mutual funds. You also asked what methodology was employed by a trustee to evaluate the appropriateness of an investment in a LBO pool which does not specify the ultimate investment of the syndicate funds.

There is no comprehensive information on pension fund investments in LBO syndicates. However, we have assembled the most reliable information we could find.

Attachment B is a July 1988 Institutional Investor article entitled "Everybody into the Pool." In this article, Institutional Investor estimates that as much as $60 billion was invested in LBO pools. The article indicates that pension funds are minor players, with foreign, institutional and individual investors playing major roles. However, Institutional Investor does not give a breakdown of LBO fund investors by type.

The best data to date on the amount of pension assets committed to LBO funds is from Pension and Investment Age (P&I). According to a 1987 P&I survey of large plans, an estimated 4 billion dollars in public and private pension monies are invested in LBO funds. Much of this (perhaps two-thirds) is accounted for by the substantial investments of a few large state pension funds. Other estimates of pension fund investment in LBO funds cited by P&I (but not sourced) are as high as $10 billion. PWBA believes the correct estimate is near the lower ($5-7 billion) end of the range.

In early 1989, P&I also noted that pension plans were reducing their commitments to LBO funds. For example, the Avon Products, Inc. pension plan, with 10 percent of its assets committed to LBO funds at the end of 1987, had the highest known percent of assets in LBO funds among private plans. P&I reported in early 1989 that Avon, along with other large pension funds, planned to reduce its LBO commitments during 1989.

The P&I findings are consistent with data reported in the July 1988 Institutional Investor. The attached article reports that LBO rates of return were declining in 1988. A decline in LBO fund rates of return would make investing even a small percent of

plan assets in a high risk investment much less attractive to private pension plans which have traditionally invested rather conservatively.

At the April hearing, you also asked about indirect pension fund investment in LBO's via the purchase of high-yield bonds held by mutual funds. The Investment Company Institute of Washington, DC defines a high yield bond fund as one where two-thirds or more of its portfolio is invested in bonds rated Baa (Moody's) or BBB (Standard & Poors) or lower. The ICI estimates that pension funds held $2.2 billion in high-yield mutual fund shares at the end of 1988.

In addition, an Institutional Investor survey of April, 1989 (see "Wary of Junk Bonds", Attachment C) indicates a stable or downward trend in pension fund investment in junk bonds. Almost 90 percent of the pension funds surveyed do not own junk bonds, and less than 10 percent of those are considering a future investment in high yield debt. Of the 10 percent of plans that do own junk bonds, more than one-third place restrictions on their junk bond managers. These restrictions include prohibitions on investments in junk bonds related to hostile takeovers or takeovers in general, prohibitions on investments in junk bonds related to LBOs, and requirements that the junk bond portion of the plan's portfolio be diversified.

Finally, during the hearings you asked how a plan trustee analyzes an investment in an LBO pool when the ultimate investment is unknown. The literature we reviewed and the pension fund managers we interviewed echoed two common themes. First, LBO pools are structured much like real estate investment partnerships. Investors frequently establish criteria which limit the set of investments for which the pool can use their funds. For example, an investor's commitment may be conditional on not investing his funds in hostile takeovers. The second common theme echoed in our review was that the willingness of a pension fund manager to commit to a certain fund is contingent upon the manager's personal familiarity with the general partner of the LBO pool and his company. A representative example of operative language from a blind pool partnership agreement appears as Attachment D.

I hope that the foregoing information will be helpful. If I can be of any further assistance, please do not hesitate to call me.

Sincerely,

Ann L. Combs
Deputy Assistant Secretary

Attachments

ATTACHMENT A

CORPORATE CONTROL CONTESTS AND PENSION PLAN TERMINATIONS

Overall Correlation Between Terminations and Corporate Control Contests

Tables A-1 - A-3 present data on trends in pension plan terminations and in corporate control contests between 1980 and 1988. Over this period, corporate control contests increased from 1940 per year in 1980 to 3292 per year in 1988--an overall increase of 1352 per year. At the same time plan terminations increased from 4058 per year in 1980 to 10,894 in 1988--an overall increase of over 6500 per year. Although corporate takeover activity could account for a small part of the increase in plan terminations during the 1980s, clearly battles for corporate control were not a primary cause of increased terminations since plan terminations increased five times more rapidly over the period than contests for corporate control.

An examination of the year-to-year changes in plan terminations and corporate control contests provides further evidence that the two trends are not closely associated. Over the eight years between 1980 and 1988, changes in corporate control contests and changes in the number of plan terminations have not always moved in the same direction. For example, as shown in the top half of Table A-3, in 1986 plan terminations decreased from 8726 to 6949, a decrease of 20 percent. At the same time, corporate control contests continued to increase, rising from 2704 to 2923 between 1985 and 1986, an increase of 8 percent.

Although there is no indication that corporate control contests are driving overall plan termination activity, it is nonetheless true that battles for corporate control may affect the small subset of pension plan terminations with asset reversions of $1.0 million or more. As shown in the second column of Table A-1, the number of plan terminations with an asset reversion of $1.0 million or more is only a small fraction of all pension plan terminations. In 1988, for example, PBGC received over 10,000 termination notices but only 206 of these were for plans with asset reversions in excess of $1.0 million. Even in 1985 at the peak of reversion activity, the 582 terminations with reversions of $1.0 million or more accounted for less than 7 percent of the termination notices received by PBGC in that year.

Because the number of terminations with substantial asset reversions is so small, the aggregate data do not rule out the possibility of corporate contests being a major factor in large asset reversions. However, the pattern of year-to-year changes in reversion activity and corporate control contests shown in Tables A-1 through A-3 does suggest that corporate control activity is not the primary factor driving plan terminations with substantial reversions. In 1986, for example, plan terminations with large

asset reversion dropped from 582 to 258, or by over 50 percent. At the same time corporate control contests continued their steady upward climb rising from 2704 in 1985 to 2923 in 1986.

Detailed Analysis of Relationships Between Termination/Reversions and Corporate Control Contests

In late 1987 and early 1988, SEC staff undertook a study to examine the relationship between pension plan terminations with large asset reversions and corporate control contests. The SEC study considered all terminations with large reversions (i.e., reversions of $1.0 million or more) between 1980 and 1987. However, because of data limitations the study only examined terminations involving publicly traded companies listed on the New York and American Stock Exchanges. Of the 1704 plan terminations with large asset reversions between 1980 and 1987, 339 involved companies listed on the New York and American Stock Exchanges.

The SEC staff examined each of the companies associated with the 339 terminated plans and determined whether each was involved in a corporate control contest either the year prior to or the year following the termination of their pension plan(s). The companies were divided into five groups:

- Companies for which there was no known corporate control contest,
- Companies that were the object of successful takeover attempts,
- Companies that were the objects of unsuccessful takeover attempts,
- Companies that "heard footsteps" (i.e., were deemed vulnerable or desireable as reported by the Wall Street Journal, and
- Companies that were involved in leveraged or management buyouts.

The findings from the SEC staff study are reported below along with PWBA's update of 1988 transactions involving Over-the-Counter as well as New York and American Stock Exchange companies.

Terminations Following Takeovers: Of the 339 plan terminations between 1980 and 1989 that involved publicly traded companies and large asset reversions, 42 (12.4%) were terminations that occurred within one year after the acquisition of the sponsor or the sponsor's parent entity.

In order to update these statistics, PWBA analyzed the 206 large reversions which occurred during 1988. In that year, 75 plans were terminated with large reversions by 50 companies listed on the New

York or American Stock Exchanges, traded "over the counter", or otherwise reliably covered by the Wall Street Journal. Of these 75 plans, 9 (12%) were terminated within one year of the acquisition of a sponsor or sponsor's parent entity.

The specific plan terminations following takeovers are listed in Table A-5.

Terminations Induced by Possible Takeovers: Pension plans may be terminated not only as the result of a takeover but also as part of a strategy to avoid a potential takeover. Thus, the SEC study analyzed the 339 termination/reversions of publicly traded companies plans to determine which companies had terminated pension plans and received large reversions one year before a successful takeover bid and one year before or after an unsuccessful takeover attempt. In addition, the SEC included in this category terminations occurring one year before successful and unsuccessful management and leveraged buyouts, on the theory that the MBO or LBO may be in response to a takeover threat or that the excess pension assets were used by management to finance a portion of the buyout.

Of the 339 plan termination/reversions studied, 37 (10.9%) fit the above description.

In order to approximate the SEC data for 1988 in the absence of complete 1989 market information, PWBA included not only those plan terminations by sponsors hypothetically expecting a corporate raid but also those terminating sponsors who could have heard "footsteps". "Footsteps" in this context means there were public reports characterizing the plan sponsor as vulnerable, underpriced, or otherwise desirable as a takeover target. Of the 75 plans included in the PWBA 1988 sample, 11 (14.7%) were terminated by plan sponsors who were later subjected to a takeover attempt, who heard "footsteps", or who were the subject of an LBO.

The specific terminations classified a possible reactions to an actual or perceived takeover attempt are listed in Table A-6.

Terminations Following LBOs and MBOs: The final category of plan termination/reversions studies by SEC staff were those that occurred within the year following a leveraged or management buyout. The SEC found that 17 (5%) of the 339 plans in their study terminated within on year after a management or leveraged buyout.

PWBA was not able to update the SEC findings for 1988 because all of the data required for an update are not yet available. The SEC data on individual 1980-87 terminations/reversions that fall into this category are presented in Table A-7.

Conclusions

Table A-4 summarizes the findings from the SEC staff study discussed above. The data indicate that as many as 28 percent of termination/reversions occurred within one year of an actual change

or restructuring of corporate control or the threat of such a change. The casual relationship, however, must be interpreted with caution. In some cases, these plan terminations, like the vast majority of plan terminations, may have occurred for business reasons that were not associated with actual or potential changes in corporate control. In other cases, the terminations may have resulted because workers in a newly acquired subsidiary were being integrated into the acquirer's pension and other employee benefit programs--programs which may offer better or worse benefits than those provided under the employee benefit programs being phased out.

The Department of Labor is currently undertaking two studies that will provide better information on the impact of changes in corporate control on workers' pension benefits. The first study, which will be completed in late September 1989, is similar to the SEC study reported above but looks at a broader set of plan terminations and of changes in corporate control. The second study, which will not be completed until the Spring of 1990, examines the actual changes in benefits experienced by workers in companies that have undergone changes in corporate control.

Table A-1

Termination Notices Received by PBGC

Fiscal Year	Termination Notices Received	With Reversion Over $ 1 Million
1980	4058	9
1981	5094	35
1982	6123	82
1983	6846	166
1984	7729	329
1985	8726	582
1986	6949	258
1987	11,075	270
1988	10,894	206

Source: Pension Benefit Guaranty Corporation, "Annual Report to the Congress" (1980-1988)

Table A-2

Control Contest Filings with SEC

Fiscal Year	SC 13D (Williams Act)	SC 13E3 (Going Private)	SC 13E4 (Self Tender)	SC 14D1 (Tender Offer)	Total
1980	1532	172	121	115	1940
1981	1644	135	133	293	2205
1982	1561	83	116	122	1882
1983	1754	56	109	99	2018
1984	2044	90	132	157	2423
1985	2301	72	126	205	2704
1986	2475	58	136	254	2923
1987	2645	58	145	193	3041
1988	2787	69	118	318	3292

Source: Securities and Exchange Commission Internal Management Information System

Table A-3

Aggregate Relation Between Termination Notices and Corporate Control Contest Filings

Fiscal Year	Termination Notices	Control Contest Filings	Ratio of Termination Notices to Filings
1980	4058	1940	2.0
1981	5094	2205	2.3
1982	6123	1882	3.2
1983	6846	2018	3.4
1984	7729	2423	3.2
1985	8726	2704	3.2
1986	6949	2923	2.3
1987	11,075	3041	3.6
1988	10,894	3292	3.3

Fiscal Year	Terminations w/ Reversions (Over $1 Million)	Control Contest Filings	Ratio of Large Reversions to Filings
1980	9	1940	.01
1981	35	2205	.02
1982	82	1882	.04
1983	166	2018	.08
1984	329	2423	.14
1985	582	2704	.21
1986	258	2923	.09
1987	270	3041	.09
1988	206	3292	.06

Source: See Tables A-1 and A-2.

Table A-4

Summary of Terminations with Reversions in Excess of $1.0 Million, 1980 - 1987

Terminations:	Number of Plans	Percent of Plans
Following Takeovers	42	12.4%
Potentially Induced by Takeover Threats	37	10.9%
Following LBOs and MBOs	17	5.0%
Not Clearly Related to Corporate Control Contests	243	71.7%
Total Large Reversions of Companies on NY and American Stock Exchange	339	100.0%

Source: Data reported by Mark L. Mitchell and J. Harold Mulherin in "Pensions and Mergers" Chapter 11 of Pension Trends, 1989, forthcoming monograph of the U.S. Department of Labor, Pension & Welfare Benefits Administration.

Table A-5. Pension terminations following takeovers

Target	Acquirer	Completion	File Date	Reversion ($ million)	New Plan
Allen Bradley	Rockwell International	Feb 21, 1985	Jun 27, 1985	1.0	NR
American Standard	Kelso	Apr 28, 1988	Jun 30, 1988	119.9	Spinoff
Bekins	Minster	Jun 21, 1983	Dec 30, 1983	11.7	NR
Beloit	Harnischfeger	Apr 1, 1986	Aug 29, 1986	18.0	DB
Butler International	North American Ventures	Jan 30, 1987	Mar 31, 1987	9.5	DB
Carter Wm. Co. (2)	Wesray Capital	Apr 29, 1988	Aug 30, 1988	5.3	DC
Cities Services	Occidental Petroleum	Dec 3, 1982	May 24, 1983	238.0	NR
Clopay Corp	Instrument Systems	July 3, 1986	Mar 2, 1987	2.8	DB
Continental Air	Texas Air	Oct 29, 1982	Oct 21, 1982	21.8	NR
Conwed	Leucadia National	Mar 21, 1985	Sep 23, 1985	2.9	NR
Diamond Crystal Salt	International Salt	Apr 26, 1988	May 31, 1988	13.4	DB
Dixico	Bell Fibre Products	Aug 28, 1985	Sep 18, 1985	4.1	NR
Dorchester Refining	Damson Oil	Aug 12, 1984	Jan 1, 1985	2.6	NR
Federal Home Life Insurance	Harcourt, Brace Jovanovich	May 24, 1985	Sep 18, 1985	4.7	NR
Foote Mineral	Newmont Mining	Apr 14, 1988	Apr 5, 1988	23.1	Spinoff

NR: None Reported
DB: Defined Benefit Plan
DC: Defined Contribution Plan

Table A-5. Continued

Target	Acquirer	Completion	File Date	Reversion ($ million)	New Plan
Getty Oil	Texaco	Feb 21, 1984	Dec 24, 1984	360.9	NR
Gino's	Marriot	Feb 5, 1982	May 10, 1982	4.5	NR
Goldenberg Plywood	Ply-Gem Industries	Apr 6, 1983	Mar 24, 1983	1.2	NR
Gulf	Chevron	Jun 17, 1984	Jun 17, 1985	1.7	NR
Host International	Marriot	Mar 4, 1982	Dec 16, 1982	4.2	NR
Houston Natural Gas	Internorth	Jul 17, 1985	May 6, 1986	232.2	NR
Houston Post	Media News Group	Nov 23, 1987	Jan 31, 1988	1.4	DC
Integon	Southmark	Jul 16, 1985	Jul 9, 1986	12.4	NR
Jonathan Logan	United Merchants	Oct 19, 1984	Feb 4, 1984	15.0	NR
Kenner Parker Toys	Tonka Corp	Oct 15, 1987	Oct 30, 1987	7.9	DC
Lane Bryant	Limited	May 28, 1982	Dec 16, 1982	14.1	NR
National Can	Triangle Industries	May 2, 1985	Aug 1, 1985	2.9	NR
National Can	Triangle Industries	May 2, 1985	Dec 23, 1985	25.4	NR
National Gypsum	Lafarge	Apr 22, 1988	Jun 8, 1988	2.1	NR
New American Library	Private Group	Nov 8, 1983	Oct 9, 1984	3.7	NR
Omark Industries	Blount	Jan 1, 1985	Jul 19, 1985	7.1	NR
Omni Spectre	N/A Com	Aug 25, 1980	Aug 24, 1981	1.1	NR
Oneite Knitting Mills	Instrument Systems	Sep 7, 1984	Aug 16, 1985	2.5	NR
Ozark Air	TWA	Sep 16, 1986	Oct 14, 1986	21.1	DB

Table A-5. Continued

Target	Acquirer	Completion	File Date	Reversion (S million)	New Plan
Ozark Air	TWA	Sep 16, 1986	Oct 16, 1987	5.0	DB
Pacific Lumber	Maxxam	Mar 26, 1986	Mar 21, 1986	50.0	DB
Piggy Wiggly	Malone & Hyde	Apr 27, 1982	Sep 24, 1982	1.1	NR
Revlon	Pantry Pride	Dec 27, 1985	Dec 18, 1985		NR
Safeguard Business Systems	Mason Best Co	Dec 23, 1986	Jun 8, 1987	3.0	DB
Stanadyne (2)	Forstmann Little	Feb 2, 1988	Jul 2, 1988	47.9	Spinoff
St Regis	Champion International	Nov 21, 1984	Nov 30, 1984	88.6	NR
Stauffer Chemical	Cheseborough-Pond's	Mar 28, 1985	Jul 19, 1985	120.6	NR
Stearns and Foster	Ohio Mattress	Dec 22, 1983	Nov 26, 1984	2.4	NR
Superior Oil	Mobil Oil	Oct 1, 1984	Dec 24, 1984	29.0	NR
Tomy	Coleco	Oct 1, 1986	Jun 24, 1987	1.8	DB
Transohio Financial	American Capital	Jul 31, 1984	Mar 25, 1985	4.3	NR
Transway International	International Control Corp	Dec 30, 1985	Nov 29, 1985	40.5	NR
Universal Rundle	Nortek	May 20, 1986	Aug 15, 1986	12.8	DC
Whiting Corp	Signal	Feb 2, 1983	Dec 20, 1983	24.2	NR

Sources: PBGC Master File of Completed Reversion Cases, and The Wall Street Journal.

Table A-6. Terminations Possibly Induced by Actual or Potential Takeovers

Firm	File Date	Reversion	New Plan	Takeover Activity
AMF	Dec 10, 1984	83.1	NR	Four months prior to hostile takeover offer
Amsted Industries	Nov 12, 1985	77.6	NR	During LBO talks
Anderson Clayton	Dec 20, 1985	82.7	NR	Five months prior to hostile takeover offer
Anta Corp.	Sep 21, 1984	33.8	NR	Nine months after hostile takeover attempt failed
ARA Services	May 8, 1984	5.4	NR	Two months prior to hostile takeover offer
Ashland Oil	Sep 29, 1986	197.7	NR	Six months after hostile takeover attempt failed
Bank Building & Equipment	Jun 30, 1987	8.6	DC	One month after self-tender offer with ESOP
Beatrice	Jun 24, 1985	12.4	NR	Four months prior to LBO offer
Becor Western	Aug 21, 1986	40.1	DB	Six months prior to LBO offer
Chromalloy American	Sep 23, 1985	19.2	NR	Nine months prior to merger offer
CMI Corp.	Sep 13, 1982	1.9	NR	During takeover talks
Crane	Oct 15, 1984	10.5	NR	Seven months after rejecting LBO offer
Del Monte	Jun 30, 1988	1.1	NR	Six months prior to LBO
Dentaply Int'l	May 21, 1982	11.3	NR	During LBO offer
Fischbach	Nov 30, 1988	35.0	DB	Two months after offer to purchase

Table A-6. Continued

Firm	File Date	Reversion	New Plan	Takeover Activity
Fruehauf	Jun 24, 1985	6.1	NR	Nine months prior to hostile takeover attempt
GAF	Aug 21, 1984	18.1	NR	Nine months after change of board control
Genstar	May 15, 1985	28.1	NR	Ten months prior to merger offer
Gulf	Apr 26, 1983	2.5	NR	Seven months prior to hostile takeover attempt
Heck's	Nov 3, 1986	4.6	DC	During LBO discussions
HH Robertson	Sep 22, 1986	4.6	DC	Seven months after change of board control
HMW Industries	Sep 23, 1983	8.7	NR	During takeover discussions
Hughes Tool	Oct 20, 1986	48.1	Spinoff	During takeover discussions
IU Truckload	Apr 24, 1988	4.2	ND	Two months after hostile tender
Management Assistance	Dec 26, 1984	6.6	DC	Four months after change of board control
Merrill Lynch	Dec 13, 1988	242.5	DC	362 days after anti-takeover plan adopted
Moore McCormick	Sep 15, 1987	11.6	NR	Six months prior to successful hostile takover
Moore McCormick	Jan 19, 1988	2.9	NR	One month prior to successful hostile takeover
NI Industries	Oct 26, 1984	2.1	NR	Three months prior to merger
NL Industries	Apr 1, 1986	150.0	NR	During takeover discussions

Table A-6. Continued

Firm	File Date	Reversion	New Plan	Takeover Activity
National Gypsum	Feb 4, 1988	11.4	NR	Two months prior to minority shareholder announcing intent to raise stake in parent to 50%
Northwest Steel	Feb 24, 1987	3.3	NR	During takeover discussions
Nutri Systems	Feb 20, 1985	1.3	NR	During LBO discussions
Plessey	Dec 26, 1985	11.2	NR	During unsuccessful takeover attempt
Portec	Dec 26, 1984	6.4	NR	During unsuccessful LBO discussions
Republic Airlines	Jul 1, 1985	4.8	NR	Six months prior to merger offer
Revere Copper and Brass	Dec 3, 1985	2.9	NR	Three months prior to merger offer
Revere Copper and Brass	Jun 6, 1986	1.6	NR	In midst of merger discussions
RJR/Archer	Jun 30, 1988	2.2	NR	Six months prior to LBO
Revlon	Dec 21, 1985	1.1	NR	During hostile takeover
Servisco	Sep 20, 1985	1.1	NR	During takeover discussions
Shand Morahan	May 30, 1985	1.8	DC	Five days after parent termed "irresistably cheap"
Signal Apparel	Sep 30, 1988	3.2	DC	Ten months after apparent Bid
Smith Industries (2)	May 1, 1988	8.4	NR	Five months before takeover attempt (Chapter 11)

Table A-6. Continued

Firm	File Date	Reversion	New Plan	Takeover Activity
Tidewater	Aug 20, 1985	6.4	NR	Seven months after hostile takeover attempt
Union Carbide	Sep 19, 1985	504.0	NR	Three months prior to hostile takeover attempt
U.S. Industries	May 21, 1984	1.9	NR	During takeover discussions

Sources: PBGC Master File of Completed Reversion Cases and The Wall Street Journal.

Table A-7. Pension terminations following leveraged buyouts and management buyouts

Firm	Completion	File Date	Reversion ($ million)	Ratio
Amerace	Sep 17, 1984	Mar 11, 1985	16.6	.10
American Sterilizer	Feb 11, 1985	Apr 1, 1985	23.3	.10
Ceco Industries	Dec 12, 1986	Sep 25, 1987	22.0	.09
Central Soya	May 13, 1985	Jul 22, 1985	36.7	.12
Cone Mills	Mar 27, 1984	Jun 22, 1984	67.5	.18
Dan River	May 25, 1983	Jun 13, 1983	19.6	.15
Levi-Strauss	Sep 3, 1985	Dec 17, 1985	53.2	.04
Midland Glass	Dec 13, 1983	Jul 19, 1984	2.4	.06
Mohawk Rubber	Jan 20, 1984	Sep 20, 1984	3.2	.04
Northwest Industries	Mar 22, 1985	Dec 23, 1985	3.3	.003
PayNSave	Jun 18, 1985	Dec 24, 1985	15.2	.04
Questor	Oct 14, 1982	Dec 1, 1982	14.2	.11
Raymond International	Nov 17, 1983	Dec 12, 1983	29.8	.18
Royal Crown	Jul 2, 1984	Jun 19, 1984	1.9	.008
SOOA Industries	Dec 11, 1985	Dec 18, 1985	43.7	.26

"Ratio" - Represents the amount of the reversion as a percentage of the transaction price.

Table A-7. Continued

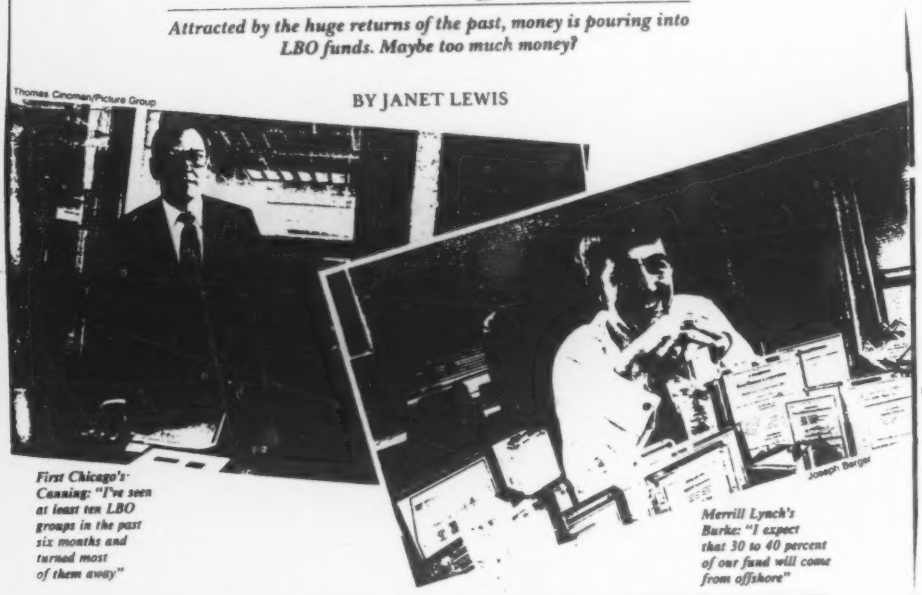
Firm	Completion	File Date	Reversion ($ million)	Ratio
Sybron	Feb 27, 1985	Dec 16, 1985	39.6	.13
US News & World Report	Jul 30, 1984	Sep 21, 1984	18.6	.11

Sources: PBGC Master File of Completed Reversion Cases, Pensions & Investment Age, Standard and Poor's Daily Stock Price Guide, and The Wall Street Journal.

Everybody into the pool

Attracted by the huge returns of the past, money is pouring into LBO funds. Maybe too much money?

BY JANET LEWIS



First Chicago's Canning: "I've seen at least ten LBO groups in the past six months and turned most of them away"

Merrill Lynch's Burke: "I expect that 30 to 40 percent of our fund will come from offshore"

Crash? What crash?

If you're in the business of managing leveraged buyout funds, you might be forgiven for asking that facetious question. To the managers of these LBO pools, the October stock market debacle was just a bad dream from which they've long since awakened. "If you had taken a vacation just before the crash and come back in January, you would hardly know anything had happened," observes an LBO fund sponsor with an air of wonderment.

The crash did change a few things for a few months: The valuations of properties tumbled, equity percentages of new deals climbed, junk-bond financing evaporated and the exit door via an initial public offering slammed shut. But with oceans of LBO-fund money flooding the market, prices have now floated back to the pre-crash high-water mark, and in some cases, crested higher. And there's no end in sight.

Attracted by the huge returns of past years — 30 percent per annum was considered paltry, and 200 percent was not surprising — from earlier LBO pools, a host of new players have started boutiques and begun collecting funds. "These days any three men on a golf course can call themselves an LBO firm," snipes one old hand. At the other end of the spectrum are recent entrants of a different kind, including General Electric Capital Corp. (see page 149).

Estimates on the total amount of money in the funds range as high as $60 billion. Although not every LBO sponsor has created a pool — some use their own money or have just one institutional backer — the funds have come to dominate the creation and funding of leveraged buyouts.

LBO funds have played major roles

"You're seeing Gresham's Law in operation — good money chasing bad."

in the biggest M&A deals of late: Kohlberg Kravis Roberts & Co.'s intervention in the Campeau–R.H. Macy battle for Federated Department Stores; Odyssey Partners' pending joint venture with West Point Pepperell to take over J.P. Stevens & Co.; Morgan Stanley & Co.'s purchase of Colt Industries with its $1.6 billion fund and the attempted buyout of Lucky Stores by the Gibbons, Green, van Amerongen Fund. "This last quarter has been incredible!" exclaims Jeffrey Kenner, president of LBO boutique Kenner & Co. "Twice as many deals have been announced as at this time last year."

Typical of Wall Street, however, is that success has bred excess. Scores of LBO fund sponsors and would-be sponsors are looking to raise even more money. "I've seen at least ten LBO groups in the past six months and turned most of them away," says John Canning Jr., president of First Chicago Venture Capital, which has committed more than $300 million to LBO equity funds as well as running deals of its own. Among the fund managers that have been pounding the pavement for $1 billion or more are Drexel Burnham Lambert, Merrill Lynch Capital Partners, Morgan Stanley, Shearson Lehman Hutton, Wasserstein, Perella & Co. and Prudential-Bache Capital Funding; many others are looking for lesser amounts, such as Adler & Shaykin's $500 million fund and Riordan, Freeman & Spogli's $400 million effort.

A lot of fundraisers have been hitting the international circuit as well, particularly Tokyo, that mecca for all those seeking ready money. "We've had a very good response from foreign investors," claims James Burke Jr., president of Merrill Lynch Capital Partners. "I expect that 30 to 40 percent of our fund will come from offshore."

Scientific choice?

How do institutions choose an LBO fund to invest in? Not very scientifically, it seems. Although they look at fund structure, the general partner's track record and similar objective criteria, personal acquaintance with the sponsor is paramount. As Eric Simonson, managing director for corporate finance at Prudential Capital Markets, explains, the important thing is "our personal knowledge and experience with the organizers in previous direct investments." Simonson says that the Pru has $700 million pledged to LBO equity funds, and more of this money is with LBO boutiques than with large investment banks.

The most common type of LBO fund is an equity pool, structured as a limited partnership with the manager as general partner; the typical customers are insurance companies, banks and a few pension funds. Some LBO fund managers, such as Forstmann Little & Co., also count fifteen to twenty high-net-worth individuals among their partners; a few LBO funds have an entirely retail client base. The institutional equity funds raise their money in the form of commitments (no checks change hands until a deal is about to close) that are available for a defined term, usually five to eight years. Most equity funds have restrictions on how much money can go into any one deal — 25 percent is common. Generally, the partnership is designed to self-destruct after ten years. General partners often have to wait for their equity profits until the investors receive a guaranteed return on equity.

Another LBO financing pool is the mezzanine LBO fund. A pool of investors holds high-yield notes and a portion of the equity. This combination gives investors a larger profit potential to compensate for the illiquidity of the investment compared with junk bonds, which enjoy a secondary market. Those with mezzanine funds include Cigna Corp., Forstmann Little, Merrill Lynch and First Boston Corp. A small $250 million fund at Morgan Stanley and Gibbons Green's $300 million-plus are for mezzanine participation in their deals. The popularity of mezzanine funds has reached individual investors; Merrill Lynch raised a retail mezzanine fund for Thomas Lee's Newhall Management Corp., which also has a retail LBO equity fund.

Yet another new twist to the LBO fund game is the bridge-loan fund, sponsored by commercial banks trying to wrest this business from the investment banks while reducing their exposure. Manufacturers Hanover Trust Co. and Citicorp are raising $1 billion each for funds that will extend bridge loans at 14 to 15 percent interest to investment banks or boutiques arranging LBOs. When so many investment banks do their own bridge lending, how many customers are these funds likely to have? "We've talked to some investment banks that find the concept intriguing," says Mark Solow, a senior managing director in MHT's investment banking group. "Many investment banks that do bridge loans are less than happy with the risk, but they have to do it for competitive reasons."

The limited-partnership structure of most LBO funds has a lot of advantages for investors and money managers. Equity investors get a crack at slick returns without doing the legwork, and they get to keep their hands on the money until it's actually invested. For the sponsors, access to such a pool of capital multiplies their clout tremendously, without leaving them too beholden to any one investor. And the term of the commitment is long enough so that, in theory, they shouldn't have to rush headlong into deals.

In practice, however, it seems that the amount of money out there has led to such frantic competition for deals that nearly every situation has turned into a bidding war. "It's a seller's market, and right now we're concentrating on selling off companies we've held in our portfolio for a while," says First Chicago's Canning. "Some of the newer funds, which don't already have full portfolios, feel a self-imposed pressure to do deals at any price."

Bad thinking, bad paper

Indeed, each player shakes his head over "all those others" who are bidding prices up to ridiculous levels and making imprudent deals that won't last through the next recession (his own deals are safe, of course). "I'm worried about the proliferation of bad thinking and bad paper," moans Theodore Forstmann, senior partner at Forstmann Little, watching the newcomers. "You're seeing Gresham's Law in operation — good money chasing bad."

Buyout fund managers and investors estimate that prices are running at eight to ten times earnings or even higher, before interest and taxes, a level many describe as foolish. "At these prices, returns will have to drop when the funds cash out in five years," says Canning. "An awful lot has to go right to get returns over 40 percent; it's just not doable at the prices paid now." Wasserstein Perella's recent $1.2 billion buyout of Pneumo-Abex Corp. was done at eight times earnings before interest and taxes. But according to Robert McKeon, a managing director at the firm, the buyers got extra value because the tax basis in the assets was raised to the price paid. "It's better than mirrors," he says.

A lot of the competition for deals is coming from newly aggressive industrial firms anxious to pick up assets, both domestic and foreign. The cheap dollar has encouraged a lot of European and Japanese companies long interested in the U.S. to take the plunge also. LBO professionals point gleefully at Bridgestone Corp.'s purchase of Firestone Tire & Rubber Co. for $2.6 billion as an example of the "incredible" prices foreign buyers will pay for strategic acquisitions. "The price the Japanese paid for Firestone is enough to knock your socks off," laughs one sponsor. Bridgestone officials defend their bid

by insisting that they needed Firestone in order to be an international force in the tire business.

Interestingly enough, overseas buying power has served to offset the problems caused by higher prices and narrowing choices of exit strategies. IPOs are far rarer during a bear market, and buy-it-and-break-it strategies lost their appeal after the 1986 tax law boosted capital gains penalties on asset sales. Normally, the reduced number of alternative exits would mean lower returns, because of the stretched-out time frame. Thanks to the decline of the dollar and the surge of money into the market, though, the LBO funds don't have to contend with normalcy these days.

If an LBO fund wants out of a deal and the Japanese aren't interested, there's always — you guessed it — another LBO group. Flipping one LBO to another LBO is gaining ground as a viable exit strategy. The LBO of the Beatrice Cos. by KKR combined this method with other strategies, netting investors more than $3 billion (*Institutional Investor*, June 1988). "We're seeing a lot of resales of corporate divisions to LBO groups," says Merrill's Burke. Recapitalization and releveraging is another way for the original LBO sponsor to exit while management increases its equity percentage. "It's like taking on a second mortgage," he explains, though the tax changes make this route more expensive. Another possibility for smaller companies is a sale to an employee stock option plan. The end result is that though everyone talks about structuring deals to last five to seven years, no one is anticipating a real stretch-out in the holding period. It seems there's always a greater fool around the corner.

Conflicts of interest

The rapid growth of the LBO and mezzanine funds has raised several questions over conflicts of interest. For example, an LBO pool sponsor managing both a mezzanine fund and an equity fund has a fiduciary duty to two investor groups that are competing for equity positions and return. Several LBO players express concern about this conflict of interest but say that their biggest worry is about a more basic issue: Are investment bankers in the LBO business for the fees or for the return on equity?

Principals in older LBO boutiques finger not only their investment bank rivals but also new boutiques, such as Wasserstein Perella, Harvest Investment Partners and Blackstone Group, that were founded by former investment bankers. Contends an LBO fund manager, "Investment bankers are classically agents, not principals; they think in terms of generating fees." Notes another LBO veteran, "There are lots of ways to structure a deal to squeeze more fee income out of it." Grumbles a third, "For some of these guys, it's like Christmas every day — between the arrangement fee, the financing fee, the management fee and so on." Asks Forstmann, "It's fine that deals create fees, but can it possibly be healthy when fees create deals?"

The accused fund managers acknowledge that the questions are heard during discussions with investors, but they staunchly defend their records and ethics. "It's a cheap shot," snaps Michael Schmertzler, president of Morgan Stanley's equity LBO fund. "I'll stand behind the equity returns we've made any day." Adds Merrill's Burke, "Our group has no interest in generating fees; our compensation is tied to return on equity and we have our own money invested in the fund." Daniel O'Connell, one of Harvest's founders and formerly of First Boston, says that the firm's general partners defuse the conflict-of-interest criticism by taking a large stake in each deal — "perhaps as high as 20 percent of the equity. We think that that is the right way to do it and that it will reassure people that we're serious about being a principal, not an agent." As for Wasserstein Perella, vice president Michael Biondi insists that, as principals in their transactions, he and his colleagues are focused on the return on equity, not on the fees they will share.

Still, there are many who think that all these eager new swimmers are jumping in just before a drought dries up the flow of deals. They worry about a possible anti-M&A administration in Washington — or worse. "If a recession comes in 1989, it will kill off some firms, no question," says Harold Rich, a second partner with Riordan, Freeman & Spogli. "The better buyout firms use a whole host of ways to lock in interest rates, but the more recent entrants to the game want to save every nickel. They won't want to pay the extra cost."

But people have been shaking their heads for years about other people's dumb deals, while the allegedly imprudent have continued to rake in the dough. Still, there has been some evidence recently that overzealous pricing has indeed occurred. Salomon Brothers' LBO of drug retailer Revco D.S. came a cropper in April when the company's management announced that it would be unable to make its June interest payment of $46 million on $703.5 million in junk-bond debt and would recapitalize; the 13.18 percent notes have lost a third of their value in the secondary market during the past several months. Apparently, the Salomon LBO was based on too-optimistic income projections. Salomon declined to comment. Overall, though, the predicted Big LBO Shakeout hasn't happened. And a lot of people are betting it won't. ■

Wary of junk bonds

Most pension funds, worried about junk-bond vulnerability to a recession, still insist on investment-grade issues.

In spite of the growing respectability of junk bonds, the current size and liquidity of their market and the returns they have generated, pension funds are still cool toward high-yield bonds for fiduciary assets. Only 11.7 percent of the funds responding to this month's Pensionforum currently own bonds rated below BBB–, and the vast majority of those funds have not increased their level of exposure over the past two years and do not expect to increase it over the next two. As for the almost nine out of ten funds that do not own junk bonds, less than 10 percent are considering such an investment.

As would be expected, larger funds are more likely to have exposure to the high-yield market: Among corporate funds with assets of $1 billion or more, 27.6 percent own some junk (a figure not given in the table). What is somewhat surprising, however, is that there is little difference in exposure or attitude between corporate and public sponsors (again a breakdown not shown), though public funds have traditionally been more conservative. The principal divergence is that public funds are more likely to have specific plan provisions forbidding non-investment-grade investments, whereas corporate funds' investment committees simply believe that the bonds are too risky.

And it is certainly the risk factor that deters wider involvement in this market, whatever the arguments of junk-bond advocates. Nearly 95 percent of all respondents expect defaults and a loss of liquidity in the next recession. And 54.1 percent foresee "a severe setback."

NO-NOS FOR MANAGERS

Of the pension funds that have investments in junk bonds, more than a third place specific restrictions on their managers. Besides nixing takeover- and leveraged-buyout-related issues, pension officials specify diversification guidelines and, for some managers, percentage limitations.

Does your fund currently have a portion of its assets invested in junk bonds (those with ratings below BBB–)?

Yes	11.7%
No	88.3

If yes, how long have you been investing in this area?

Less than a year	12.1%
Between one and three years	36.4
Between three and five years	33.3
More than five years	18.2

What percentage of your fixed-income portfolio do junk bonds represent?

Less than 1 percent	59.6%
1 to 5 percent	10.5
6 to 10 percent	5.3
11 to 20 percent	12.3
More than 20 percent	12.3

What percentage of your total assets do junk bonds represent?

Less than 1 percent	65.5%
1 to 5 percent	19.0
6 to 10 percent	10.3
11 to 20 percent	3.4
More than 20 percent	1.8

Over the past two years, has the percentage of your total assets devoted to junk bonds:

Increased?	12.0%
Decreased?	9.4
Remained the same?	78.6

Over the next two years, do you expect the percentage of your total assets devoted to junk bonds to:

Increase?	8.1%
Decrease?	3.5
Remain the same?	88.4

Do you place any restrictions on your junk-bond managers?

Yes	38.3%
No	61.7

If yes, what kinds of restrictions?

Don't allow junk bonds related to unfriendly takeovers	15.8%
Don't allow junk bonds related to any takeovers	10.5
Don't allow junk bonds related to leveraged buyouts	10.5
Don't allow junk bonds below a certain credit rating	15.8
Other	52.6

ATTACHMENT D

1 Oak Way
Berkeley Heights, NJ 07922-2727
201 771-2000

May 15, 1989

Mr. Patrick O'Brien
Suite S-2524
U.S. Department of Labor
Washington, DC 20210

Dear Pat:

Pursuant to our recent conversation, attached are two pages from one of our partnership agreements that disallows investments in hostile takeovers. The relevant passage is marked.

It's important to stress that this is only one agreement and, while such covenants are not uncommon in these documents, it cannot be used as something that is representative of all partnership agreements. Each partnership has a particular approach to the market, and each partnership agreement is unique. There are always points that we strive for in the agreement negotiations, but as in any negotiation process, we win some and we lose some. In the end, we look at the negotiated agreement as a package, and decide whether or not the terms are advantageous to our fund (and therefore our beneficiaries) on balance.

Another critical element that we view as an integral part of the final package of terms is the track record of the general partner. In the hostile takeover situation, for example, the language of an agreement might prohibit "hostile takeovers," but as you know, it can become difficult if not impossible for reasonable people to agree on whether or not a particular transaction is actually "hostile." The Board, after all, always votes to accept some course of action eventually. The record of the general partner is therefore, in our opinion, equally if not more important than the language in the agreement.

I hope that this and your contact with Linda Vincent at Venture Economics have helped to answer some of your questions. The complex and specialized nature of this kind of investing can be daunting, I know, and if some of the subject matter experts in my group can help further by meeting with you, I have been assured that they would be happy to do so.

Sincerely,

Alison Peeler

Alison Peeler

"Person" shall mean any individual, partnership, corporation, unincorporated organization or association, trust or other entity.

"Substituted Limited Partner" shall mean any Person admitted to the Partnership as a Limited Partner pursuant to the provisions of Section 9.3.

"Transfer" shall have the meaning ascribed to such term in Section 9.1.1.

"unfunded Capital Contributions" shall mean Capital Contributions that have not yet been paid to the Partnership, including any amounts deemed unfunded Capital Contributions pursuant to Section 3.3.5.

ARTICLE TWO

Organization

2.1 Formation. The parties have formed a limited partnership pursuant to the provisions of the Partnership Act. The rights and liabilities of the Partners shall be as provided in said Partnership Act, except as herein otherwise expressly provided.

2.2 Name. The name of the partnership shall be However, the business of the Partnership may be conducted, upon compliance with all applicable laws, under any other name (other than the name of a Limited Partner) designated in writing by the General Partner to the Limited Partners.

2.3 Place of Business and Office; Registered Agent. The Partnership shall maintain its principal office at The General Partner may at any time change the location of the Partnership's offices and may establish additional offices. Notice of any such change shall be given to the Limited Partners on or before the date of any such change. The name and address of the Partnership's registered agent is

→ 2.4 Purpose. The principal purpose of the Partnership is to seek out opportunities for investment, and to make investments, that offer the possibility of long-term equity appreciation, principally through the purchase of existing businesses on a leveraged basis with the participation of members of senior management of such

businesses. Such investments will usually be made in the securities of new corporations to be formed by the Partnership, the General Partner or others for the purpose of acquiring the existing business, which may be a privately-held enterprise, a publicly-owned enterprise, or subsidiaries or divisions thereof, in each case the business of which is conducted primarily in the United States of America. While the primary focus of all Partnership investments will be on common stock equity ownership in Acquired Businesses, such investments may be in the form of shares of common stock, shares of preferred stock, debt obligations (senior or subordinated, so long as any such debt is convertible into an equity Ownership Interest or is accompanied by an equity Ownership Interest or warrants, rights or options to acquire an equity Ownership Interest), warrants, rights or options to purchase equity securities, or other like arrangements, or any combination thereof, as determined by the General Partner (such securities as are actually acquired by the Partnership being referred to as "Ownership Interests"). While the Partnership may participate in tender offers or other means of pursuing an acquisition, the Partnership will not pursue the acquisition of a business if (i) such acquisition is opposed by such business' board of directors or by stockholders possessing a majority of the voting power of such business' outstanding securities, or (ii) such acquisition is prohibited by law. The Partnership shall engage in no other business.

2.5 Term. The term of the Partnership commenced on January 6, 1988 and shall continue in full force and effect until December 31, 1997, unless further extended for up to two additional one-year periods from such date if the General Partner determines, in each instance, that such extension is in the best interests of the Partnership, or until dissolution prior thereto pursuant to the provisions hereof.

2.6 Qualification in Other Jurisdictions. The General Partner shall cause the Partnership to be qualified, formed, reformed or registered under assumed or fictitious names or foreign limited partnership statutes or similar laws in any jurisdiction in which the Partnership owns property or transacts business if such qualification, formation, reformation or registration is necessary in order to protect the limited liability of the Limited Partners or to permit the Partnership lawfully to own property or transact business, and shall cause the Partnership not to transact business in any such jurisdiction until it is so qualified, formed, reformed or registered. The General Partner shall execute, file and publish all such certificates, notices, statements or

Chairman PICKLE. Now, Mr. Trier, I want to ask you a question pertaining to the ongoing question we always have about these excess assets when there is a termination about whether the money should go to the workers or to retirees.

Under the current law, does the financial condition of a defined benefit pension plan affect the benefits that participants are entitled to receive?

Mr. TRIER. Yes. To make sure I understand your question, under a defined benefit plan, does it affect the amount they are entitled to receive. No, it does not. In other words, there is a defined liability under the plan, and the extent to which the assets in the plan are greater than that does not add to the amounts the participants are entitled to receive.

Chairman PICKLE. So, the financial condition of the fund really has no bearing.

Mr. TRIER. Unless it were way low, but has no bearing on what they are entitled to receive.

Chairman PICKLE. The point I want to make is we really make a promise that there will be certain benefits available, but they are not tied to funding. There might be something specific in a defined contribution plan, but not in a defined benefit plan.

Mr. TRIER. Unless the employers happen to grant that right.

Chairman PICKLE. Then my next question would be under the current law, is there any requirement that an employer fund defined benefit plans in a way that causes excess assets to accumulate in a plan?

Mr. TRIER. It is a fairly complicated question, but——

Chairman PICKLE. I don't think so, Mr. Trier. You know there is not.

Mr. TRIER. No, there is not.

Chairman PICKLE. Now, what we have really got is we just don't have any real standards for any extra contribution to the fund. We allow it, but we don't require it. That is the bottom line, and that can be a problem for us, to determine should we do something about it after a termination. I think we ought to admit that and lay that down as the record.

Now, if the benefits owed to a participant in a defined pension plan are unaffected by the funding status of the plan, which you just, in effect, said, but would be affected by the plans termination, should a company be allowed to withdraw assets without terminating the plan?

Mr. TRIER. I think that is a question that is addressed by the joint guidelines, and that it is a policy issue that should be addressed, but under today's law, it cannot——

Chairman PICKLE. You gave me a rather faltering answer. It is a problem and a serious problem. The fact of the matter is, I think we ought to recognize this whole pension business, it is the termination of the plans, regardless whether it is LBO, regardless whether it is excess or unfunded, but it is actual termination that is the problem, is it not?

Mr. TRIER. That is the problem, yes, sir.

Chairman PICKLE. That is something that ought to be looked at, and I think you are going to hear a lot more about this question as we study this asset reversion situation.

Dr. Utgoff, I think to me, one of the most significant things that I think you said, or maybe it was Mr. Walker, anyway, you talked about the number of plans studied where we have these terminations with respect to LBO's.

I think you said that 40 percent of the cases, in 40 percent of the cases that LBO's led to the termination of the company's pension plans. That is an high percentage, at least where there is an LBO involved.

I ask you, is there any aspect of pension plan termination and reversion after an LBO that is worse than other cases where plan termination and asset reversion have been involved?

Ms. UTGOFF. No. LBO's really are not the feature that affects benefits right here.

Chairman PICKLE. Then LBO's or the financial condition of the plan are really not the determinative factor. The factor really is the plan termination, I guess, no matter what the cause, whatever cause, it is the same result; isn't it?

Ms. UTGOFF. Right. We have about 8,000 or 10,000 plan terminations a year of defined benefit pension plans, and most of the problems that are talked about can be applied to all of those, not just the very few cases of reversions and the few of those cases again that are still LBO's.

I think you ask a very good question, and the focus should be on plan terminations and not on LBO's or asset reversions if you want to address the real——

Chairman PICKLE. That is the key question to keep in mind as we pursue this thing, how does it affect the worker? You mentioned Kaiser Steel, and you showed in the case where they had this bankruptcy that PBGC really ended up with the short end of the stick.

Ms. UTGOFF. Yes.

Chairman PICKLE. And the bondholder, or the shareholders got the money. If that is true of Kaiser and that case is under litigation, and you are trying to reverse some of that now, are there other companies pending where this same thing can happen?

Ms. UTGOFF. This is a general problem for the PBGC. There are a variety of corporate actions, restructurings, financial goings-on that can take place where people can come in and secure the assets of a company that really should be there to protect the pension plan. This is not particular to LBO's, but it is a real problem in LBO's.

When a pension plan is terminated, much of our claims are unsecured, and companies can do a variety of things that really jeopardize the claims of the pensioners and our claims through them in bankruptcy.

Chairman PICKLE. Well, in some of the reorganization plans, whether as a result of the bankruptcy, the real advantage goes to bondholders or shareholders, does it not, as against the PBGC?

Ms. UTGOFF. Right, the shareholders.

Chairman PICKLE. If that is true in Kaiser, would it not be true in Eastern Air Lines?

Ms. UTGOFF. Yes. The problem is similar. When a company is broken up or a new financial transaction is talked about, money can be distributed to shareholders or to owners. In the instance of Eastern Air Lines, I think you bring up a good case, in that East-

ern is a member of a control group with Texas Air and Continental, and the pension is protected by that membership.

When there is a sale that takes Eastern out of that controlled group and people talk about distributing money in that sale to either Frank Lorenzo or to the creditors or all the other people involved, we worry about how that is going to affect the rights of the pensioners and us to the assets of the company. So you ask a very good question.

Chairman PICKLE. If the advantage goes to the shareholders now in these reorganization cases, and you are concerned about that, have you made any recommendations for changes?

Ms. UTGOFF. As you know, we had a significant bill that was passed about 1½ years ago which changed a great deal of the lay of the land in this area. It made it harder to terminate plans. It increased some of our power in bankruptcy. It still may be a problem, but I think we have to recognize that significant steps have been taken to try to address some of the worst areas.

Chairman PICKLE. Significant steps may have been taken in the program we changed some time ago, 3 years ago, but the question now must be a serious one, because you have just now testified in a good portion of your time allotted, you think this is a serious problem and PBGC is hurt.

So, whatever changes we have made, we haven't made enough, have we? Have you made any recommendations to the Judiciary Committee?

Ms. UTGOFF. I have testified in the past, and I continue to personally believe if this continues to be a problem, we don't know that it is a problem yet, that if it continues to be a problem——

Chairman PICKLE. I don't understand, Dr. Utgoff. You just got through telling me how bad you have been hurt in the Kaiser Steel, and now you don't know how bad you have been hurt.

Ms. UTGOFF. The question, is Kaiser an unusual case? We are going after everyone in the Kaiser case. The legal remedy here may be an action over what is called fraudulent conveyance, which is in fact an illegal activity.

If it is not an illegal activity and it proves to be a recurring problem, I think there are several remedies that ought to be considered. One of those, and I have talked about it before, is, in fact, that the priorities of pension debt in bankruptcy ought to be examined.

Chairman PICKLE. You mean you suspect there has been fraud involved in the transactions?

Ms. UTGOFF. There has been fraud alleged in the Kaiser case.

Chairman PICKLE. That is what you are pursuing, but you think you have sufficient laws otherwise?

Ms. UTGOFF. We don't know. As one of the lawyers have aptly characterized it at the PBGC, it is old law in very new financial transactions, and we don't know how this case will turn out. It is frontier law. It is a very complicated transaction.

The Kaiser litigation is aimed at shareholders, directors, everybody involved in the Kaiser transaction, and I am sure it will be 10 years before there is any resolution.

Chairman PICKLE. I want to say to the committee, we have a lot of unanswered questions, obviously, that we have discussed here

this morning. We all recognize the fact that the amount of investments in LBO's by pension plans are very small related to the overall program.

Yet, dollarwise, it is becoming a very large problem, and it is going to grow, because these pension funds are becoming bigger than the government. You have to ask yourself, what do we do, if anything, about it, or should we do anything about it, and if by the year 2000, in fact, pension fund assets would control some 40 percent of corporate America, I think it is time for us to pause to think about that.

I don't know that I am prepared to say it is good or bad, but that is a fact, and we also must recognize the fact. Whether we want to say there is proof of it, when you have investment in junk bonds, though in many cases they may be desirable, we have got to admit, as you have, that they are risky investments. They are down the ladder as far as security is concerned, and in an economic downturn, they might hurt.

I think we need to know what is happening. But most of all, whether it is LBO's or its a regular asset reversion or termination, it looks to be like the bottom line is that the employee, the retiree, is hurt because they get promised for reimbursement on their top years, plus times the number of years of work and the new plan often won't take into account their past service credit.

I think those are problems we have to look at. Now, the committee is going to submit to you some additional questions as a follow-up. We don't have time to pursue it any further, because we have three other panels. But I want to thank you for your help and participation this morning.

[No further questions were submitted.]

Chairman PICKLE. The next witness will be Mr. Joseph Delfico, representing the GAO. He is a senior associate and Director of the Human Resources Division.

Mr. Delfico, if you will proceed, sir?

STATEMENT OF JOSEPH F. DELFICO, DIRECTOR OF INCOME SECURITY ISSUES (RETIREMENT AND COMPENSATION), HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY ROBERT HUGHES, ASSISTANT DIRECTOR, PENSION BENEFITS AUDIT SITE, AND JOHN HANSEN, SENIOR EVALUATOR

Mr. DELFICO. Thank you.

With me today is Robert Hughes, in charge of my pension work; and on my left is John Hansen, who is the principal analyst in the work we have done for the committee. Also in the audience is Charles Vrabel and Harry Johnson, who helped us prepare this testimony.

With your permission, I would like to present a brief, 5-minute summary of my testimony and present the full testimony for the record.

I am pleased to be here today to discuss the preliminary results of our work on the role of pension plans in LBO's. LBO's have increased dramatically in the past few years, more than tripling from 99 in 1981 to 318 in 1988. The value of these transactions also rose

sharply, from $3.1 billion in 1981 to $42.9 billion in 1988. Typically, LBO's involve the acquisition of a public company by a group of investors who purchased company stock using mostly borrowed funds with the acquired company's assets as collateral.

Among the concerns that you and others have expressed about LBO's are the implications for pension benefit security, and the role of pension funds in financing LBO's. At your request, our work to date has focused on identifying the incidence of pension plan terminations by companies that have been taken over in an LBO. We have also reviewed the investment of eight large public and private pension plan sponsors in limited partnerships called LBO funds. These funds are used to help finance LBO's.

We focused our analysis on 190 companies for which LBO's were announced from 1982 through 1987. The 190 companies sponsored 899 pension plans before the data on which the LBO was announced. These included 656 defined benefit plans and 243 defined contribution plans covering about 1.6 million participants. The 899 plans had about $5.7 billion in assets.

Almost 40 percent of the 190 companies taken over in LBO's terminated pension plans after the takeover. These terminations involve 107 defined benefit plans, and 23 defined contribution plans covering about 290,000 participants. The terminated plans had about $1.8 billion in assets at the time of the plan termination.

PBGC records for the 107 terminated defined benefit plans showed that the plans which were sponsored by 61 companies, covered about 159,000 participants and had about $1.7 billion in assets at the time of terminations.

The plan sponsors, not the participants, received the vast majority of the asset distributions. Of the 107 plans, 85 were terminated with assets in excess of the amounts needed to pay benefits. PBGC records show that in only four terminations, all the excess assets, about $2.7 million were distributed to the plan participants. In two other terminations, the distribution of excess assets was split, with the sponsors receiving the vast majority of the assets.

For the remaining 79 terminations, that is roughly 93 percent of all terminations with excess assets, the plan sponsors obtained a reversion of excess assets of about $582 million, or 34 percent of total plan assets. The reversions to the plan sponsors average $7.4 million with plan and range from a low of only $490 for a very small plan to $64.4 million. A primary reason given for the terminations was the sale or transfer of the company.

Sponsors for about 40 percent of the terminated plans stated that they intended to cover the participants with an existing plan, a new plan or a spin-off plan. However, most of the new plans established were defined contribution plans rather than defined benefit plans.

Our data base showed that 23 terminated defined contribution plans had about $149 million in assets and covered about 131,000 participants. Unlike defined benefit plans, assets in defined contribution plans belong solely to the participants, and assets did not revert to plan sponsors.

One way that pension plans can participate in an LBO is to invest in LBO funds that pool capital provided by large investors.

The funds are formed as limited partnerships by firms that specialize in LBO's, and typically provide about 15 percent of the financing for the LBO transactions.

The eight public and private pension plan sponsors we contacted had invested $3.4 billion or 3.7 percent of their combined plan assets in 53 LBO funds. The proportion of plan assets each sponsor invested in these funds range anywhere from 0.4 percent to 8.4 percent.

LBO fund investments involve several types of risk. For example, there is a liquidity risk, because plan assets are committed to a partnership for as long as 10 to 12 years, and the partnership interest cannot be traded on the open market like stocks and bonds can be traded. In addition, an economic downturn could result in the acquired company not having sufficient assets to pay off the large amount of debt issued for the acquisition.

The rate of return the sponsors have obtained under LBO fund investments, with one exception, has greatly exceeded the return obtained on total plan investments. The return on LBO fund investments range anywhere from 10.5 percent to 40 percent, while the return on total plan investments range from 9 percent to 16.1 percent.

It is interesting to note, Mr. Chairman, that four of the LBO funds in which the plan sponsors invested had financed LBO's for eight of the companies that eventually terminated their pension plans.

We are continuing our work in this area to determine what the role of the LBO is in deciding to terminate these plans and how the terms of any followup plans established for company employees compared to those of the terminated plans.

Mr. Chairman, this completes my statement. I would be happy to answer any questions you might have.

[The statement of Mr. Delfico follows:]

STATEMENT OF JOSEPH F. DELFICO, DIRECTOR OF INCOME SECURITY ISSUES, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the preliminary results of our work on the role of pension plans in leveraged buy-outs (LBOs).

LBOs have increased dramatically in the past few years. In February 1989, the Congressional Research Service reported that the number of LBOs more than tripled from 99 in 1981 to 318 in 1988. The value of these transactions also rose sharply-- from $3.1 billion in 1981 to $42.9 billion in 1988. Typically, LBOs involve the acquisition of a public company by a group of investors who purchase the company's stock using mostly borrowed funds with the acquired company's assets as collateral.

Congressional concerns about LBOs were heightened following the recent takeover of RJR Nabisco for about $25 billion. These concerns have included the tax consequences of LBOs that replace equity with debt, the ability of debt-laden companies to withstand economic downturns, and the impact of LBOs on company productivity and performance.

Among the concerns that you and others have expressed about LBOs are the implications for pension benefit security and the role of pension funds in financing LBOs. These concerns raise several questions regarding (1) the incidence of pension plan terminations by companies taken over in LBOs, (2) the extent of pension plan investments in limited partnerships used to help finance LBOs, and (3) the risk of investing plan assets in LBOs.

As requested in your February 10, 1989 letter, and as discussed with your office, our work to date has focused on identifying the incidence of pension plan terminations by companies that have been taken over in an LBO. We have also reviewed the investments of eight large public and private pension plan sponsors in limited partnerships (called LBO funds) used to help finance LBOs.

PLANS TERMINATED BY COMPANIES TAKEN OVER IN LBOs

We focused our analysis on 190 companies for which LBOs were announced from 1982 through 1987. The 190 companies sponsored 899 pension plans before the date on which an LBO was announced.[1] These included 656 defined benefit plans and 243 defined contribution plans covering about 1.65 million participants. The 899 plans had about $15.7 billion in assets.

Almost 40 percent of the 190 companies taken over in LBOs terminated pension plans after the takeover. These terminations involved 107 defined benefit plans and 23 defined contribution plans covering about 290,000 participants. The terminated plans had about $1.8 billion in assets at the time of plan termination.

Defined Benefit Plans

Our analysis of the Pension Benefit Guaranty Corporation's (PBGC's) records showed that 61 companies taken over in LBOs terminated 107 defined benefit plans. The 107 plans covered about 159,000 participants, and had about $1.7 billion in assets at the time of termination.

Although we did not contact these plans during this phase of our work, PBGC's records show that a primary reason plan sponsors cited for defined benefit plan terminations was the sale or transfer of the company.

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[1]Our methodology is discussed in more detail in appendix I.

Timing of Terminations

The timing of a plan termination may suggest what role, if any, an LBO played in the sponsor's decision to terminate the plan. For example, a sponsor could terminate an overfunded plan before an LBO in an attempt to make the company a less attractive takeover target. A sponsor could also terminate a plan after an LBO to obtain any assets that exceeded what was needed to pay participants' benefits.

Of the 107 terminations, 23 occurred between the LBO announcement date and the date on which the LBO occurred. The other 84 terminations (about 78.5 percent) occurred within various time periods after the LBO. For example, 39 of the 84 terminations (about 46 percent) occurred within a year after the LBO.

Distribution of Plan Assets After Termination

Two of the 107 plans were terminated with insufficient assets to pay plan benefits. Seventeen plans were terminated with assets equal to benefits, and three were terminated with excess assets, but without documentation in PBGC's records explaining how they were distributed. The remaining 85 plans (about 79 percent) were terminated with assets in excess of the amount needed to pay benefits. PBGC's records show that in four terminations, all the excess assets, about $2.7 million, were distributed to the plan participants. In two other terminations, the distribution of excess assets was split, with the sponsors receiving $8.4 million and the participants $593,498. For the remaining 79 terminations with excess assets, the plan sponsors obtained a reversion of excess assets of about $581.6 million, or about 34 percent of total plan assets. The reversions to the plan sponsors averaged $7.4 million per plan, and ranged from $490 to $64.4 million.

PBGC reports reversion data for plans with reversions of $1 million or more. These data show that from 1982 through 1988, 1,853 plans were terminated with reversions of $19.7 billion. The average reversion was $10.6 million. Fifty-two of the terminated defined benefit plans we reviewed had reversions of over $1 million. The average reversion for these plans was $11.1 million.

Characteristics of Plans After Terminations

Sponsors for about 40 percent of the terminated plans stated that they intended to cover the participants with an existing plan, a new plan, or a spin-off plan. For example, nine sponsors said they intended to establish a new defined benefit plan, and three said they would cover the participants under another existing defined benefit plan. Twenty-two sponsors said they intended to establish a new defined contribution plan, and one said that participants would be covered by another existing defined contribution plan. Eight other sponsors said they intended to cover participants with a spin off plan.

We were unable to determine from the PBGC records we reviewed during our preliminary work whether the remaining sponsors intended to cover participants in the terminated plan with a new or existing plan.

Defined Contribution Plans

Our data base of pension plan annual returns (form 5500) filed with the Internal Revenue Service (IRS) showed that 21 companies terminated 23 defined contribution plans with about $149 million in assets, covering about 131,000 participants. Nine of these companies also terminated at least one defined benefit plan. Unlike defined benefit plans, assets in defined

contribution plans belong solely to plan participants. As a result, there is no reversion of excess assets to the plan sponsor.

Defined contribution plan termination data, however, is not as reliable or as timely as the information on defined benefit plan terminations. Unlike defined benefit termination data, defined contribution data are not reported to PBGC; thus, there is no cross-check on the quality of the data. There are longstanding problems in the quality of the form 5500 data base, and there is also a time lag between the end of a plan year and when the annual return must be filed with IRS.

Because of problems with the data on defined contribution plans, and the lack of any claim to plan assets by the sponsor, we focused our attention on defined benefit plan terminations.

PENSION PLAN INVESTMENTS IN FUNDS USED TO FACILITATE LBOs

One way that pension plans can participate in LBOs is to invest in LBO funds that pool capital provided by large investors.[2] The funds are formed as limited partnerships by firms that specialize in LBOs. The firms serve as the general partner for the fund, and the pension plans and other investors are limited partners. Typically, LBO funds provide about 15 percent of the financing for the LBO transaction.

The eight public and private pension plan sponsors we contacted had 138 defined benefit plans with over $93 billion in assets. These sponsors had invested about $3.4 billion (about 3.7 percent of their combined plan assets) in 53 LBO funds. The proportion of plan assets each sponsor invested in these funds ranged from 0.4 to 8.4 percent.

The plan sponsors must decide to commit to the fund without knowing the specifics of any acquisition. Essentially, the plan is investing in a "blind pool," in which it has no input concerning the company to be acquired or the price of the acquisition. As a result, the plan's evaluation focuses on such factors as the reputation, experience, and track record of the general partner as an LBO manager. Other factors that are examined include the investment criteria used to select acquisition targets, the minimum required capital commitment of the limited partners, profit or loss distribution between the general partner and the limited partners, and management fees.

LBO fund investments involve several types of risk. For example, there is a liquidity risk because plan assets are committed to a limited partnership for as long as 10 or 12 years, and the partnership interest cannot be traded on the open market like stocks or bonds. In addition, an economic downturn could result in the acquired company not having sufficient assets to pay off the large amount of debt issued for the acquisition.

The rate of return the sponsors have obtained on their LBO fund investments, with one exception, has greatly exceeded the return obtained on total plan investments. The returns on LBO fund investments ranged from 10.5 to 40 percent, while the return on total plan investments ranged from 9.0 to 16.1 percent.

It is interesting to note, Mr. Chairman, that some of the plan sponsors we visited had invested in LBO funds that financed takeovers of companies that terminated pension plans. In

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[2]We testified on private pension plan investments in LBO funds on February 9, 1989, before the Subcommittee on Labor-Management Relations, House Committee on Education and Labor (GAO/T-HRD-89-5).

reviewing the takeovers financed by four of the LBO funds in which the plan sponsors invested, we found that 8 of the companies that were taken over terminated pension plans.

CLOSING OBSERVATIONS

In summary, almost 40 percent of the companies that were taken over in LBOs terminated 107 defined benefit pension plans with reversions of excess assets of over half a billion dollars, most of which went to the plan sponsors. For 43 of the 107 terminations, the sponsor intended to cover the participants with a new pension plan or an existing or spin off plan. Many of the new plans to be established were defined contribution plans.

The eight pension plan sponsors we contacted have invested a relatively small portion of their assets in LBO funds and have received higher returns than achieved on other plan investments. Further, the plans appear to have been selective in choosing LBO funds in which to invest and have diversified their investments among different funds. Four of the LBO funds in which the plan sponsors invested had financed LBOs of 8 companies that terminated pension plans.

We are continuing our work in this area to determine (1) what the role of the LBO is in the decision to terminate these plans and (2) how the terms of any follow-on plans established for company employees compare to those of the terminated plans.

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Mr. Chairman, this completes my statement. I would be happy to answer any questions at this time.

METHODOLOGY FOR IDENTIFYING PENSION PLANS AND PLAN TERMINATIONS FOR COMPANIES TAKEN OVER IN LEVERAGED BUY-OUTS

To identify the number of LBOs, we used information from a study coauthored by the Chief Economist of the Securities and Exchange Commission that identified 284 public companies for which LBOs were announced[3] from 1980 through 1987. We reduced the number of companies by 94 for several reasons.

We excluded 24 companies because we could not identify either a reliable date on which the LBO occurred[4] or a valid employer identification number used for tax purposes. We excluded another 40 companies where the LBO was announced during 1980 and 1981, because our data base of pension plan annual returns (forms 5500) did not go back far enough to enable us to identify the number of plans each company sponsored in the year preceding the LBO. Twenty-five companies were excluded because we were not able to identify any pension plans for the company's employer identification number. Finally, we excluded five companies because we could not obtain asset or participant data for the plans they sponsored.

As a result, we focused our analysis on 190 companies for which LBOs were announced from 1982 through 1987. These companies sponsored 656 defined benefit plans with $10.8 billion in assets, covering 920,691 participants.

We used pension plan annual returns (form 5500) to identify terminated defined contribution plans and determine their characteristics. PBGC does not insure defined contribution plans, and, therefore, does not maintain information on them. We found that the 190 companies sponsored 243 defined contribution plans with $4.9 billion in assets covering 731,710 participants.

It is possible that there were pension plans that we did not identify because the form 5500 data base is incomplete or the plans' tax returns were filed under a different name or employer identification number. Also, this data base excludes plans with less than 100 participants that file different returns.

We used PBGC's pension plan termination data base to identify (1) defined benefit plans sponsored by companies in the LBO data base that had been terminated, (2) the reason for the termination, (3) whether there was a reversion of excess assets to the plan sponsor, and (4) whether the sponsor intended to establish a replacement plan. To determine when the plan termination occurred in relation to the LBO, we compared the date of plan termination to the date on which the LBO was announced and the date on which it occurred.

We identified several plans with over 100 participants that were not included on our form 5500 data base. We used PBGC asset and participant data for these plans.

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[3]The date on which the LBO was announced represents either the date on which (1) the Wall Street Journal reported that an investor had expressed an interest in acquiring a company in an LBO, (2) an investor notified the Securities and Exchange Commission of its intent to pursue an LBO, or (3) the company's board of directors announced that they had agreed to an LBO.

[4]The date on which the LBO occurred represents the last date on which the company's stock was publicly traded.

Chairman PICKLE. Thank you, Mr. Delfico.

Mr. Delfico, why are the defined contribution plans growing as opposed to the defined benefit plans?

Mr. DELFICO. A couple of reasons that have been reported are that defined contribution plans are easier to administrate by a company, so there is an incentive to change from a defined benefit plan to a defined contribution plan. Of course, the other side of it is that a defined contribution plan shifts the risk to the participant.

Chairman PICKLE. I listened to your statement about the number of plans you examined. It looks to be like a lot of the plans that are overfunded, are being targeted in these LBO's. Is that a fair analysis to make?

Mr. DELFICO. Yes, we noted that is the case for 40 percent of the companies in our termination data base.

Chairman PICKLE. That is a fundamental truth we have to accept, don't we?

Mr. DELFICO. I think the PBGC study has shown the incidence of terminations are higher for LBO's than for terminations in general, so there is an indication of that.

Chairman PICKLE. Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman.

That means in 60 percent of the cases it does not, so the preponderance would be it is not a determinant. Is that correct?

Mr. DELFICO. That is correct, in 60 percent of the cases companies did not terminate plans. I would like to clarify another point. I didn't mean to imply that the overfunded plan itself was the reason for the LBO. It may be one factor, but determining the causal link between the termination and the LBO is very difficult to do, and we haven't done that to date.

It is just a correlation, and that is the state of our analysis.

Mr. SCHULZE. Have you reached any conclusions as to why pension plans are terminated following leveraged buyouts?

Mr. DELFICO. Right now, it is speculation. We spent 6 weeks gathering the data and analyzing it, so we don't know why. We will be talking to plan sponsors in the next phase to find out answers to that particular question.

Mr. SCHULZE. In earlier questions, I stated it seemed to me to be normal in the acquisition process that a larger company would most often be taking over a smaller company. It seems to be logical that their pension fund would be the survivor of the two, and that the smaller company's pension fund would be dissolved, and folded into the other.

Is that a logical sequence of what happens, or is that not what happens?

Mr. DELFICO. Well, some of the LBO's we looked at, that had plan terminations after an LBO involved investment groups. However, we didn't look at all mergers and acquisitions.

So, I am not prepared to answer that particular question.

Mr. SCHULZE. What portion of takeovers and acquisitions are done by financial groups rather than a company acquiring other companies?

Mr. DELFICO. We don't know the answer to that one.

Mr. SCHULZE. If it is one-half of 1 percent, it is really not much of a problem. If it is 80 percent of acquisition, then it seems it could

be a problem. Mr. Delfico, in your statement, you indicate you have examined the LBO transactions of 190 companies sponsoring 656 defined benefit plans and that 60 of those companies terminated 107 defined benefit plans subsequent to the LBO.

Were the 107 plans which were terminated more or less overfunded than the remaining 549 defined benefit plans which were not terminated?

Mr. DELFICO. We know the 107 by and large were overfunded. Do we have any information on the other?

Mr. HUGHES. Sir, we do not know the funding status of the other plans. For the terminations, we were able to look at PBGC records and determine their funding status.

Mr. SCHULZE. Are we looking at this in an unbiased way or are we going predetermined we want to make a case? Because it seems if the others were overfunded, it refutes the premise that this is the driving force.

Mr. DELFICO. Our focus was to look at plans that were terminated, and that was our starting point after an LBO. You are right, there were some plans that kept going. We haven't looked at whether they are overfunded or underfunded.

Mr. SCHULZE. Is there a relationship between the additional debt taken on by the company and the amount of money that subsequently reverted in the termination of the overfunded pension plans?

Mr. DELFICO. I would say there may be a correlation between the debt and the amount of terminated money in the pension fund.

Mr. SCHULZE. Can you put a percentage on that relationship?

Mr. DELFICO. We can in our study. Right now, we are not prepared to talk about that.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. DORGAN [presiding]. Thank you, Mr. Schulze.

Mr. Delfico, the GAO, in reviewing the impact of pension plan investments on LBO's concludes they have generally been very profitable for the pension plans, I guess. The yield generally is a result of risk; is it not?

Mr. DELFICO. It correlates with risk, yes.

Mr. DORGAN. So the profitability of the investments and the instruments that are involved in LBO's provide higher yield because they are significantly higher risk; is that right?

Mr. DELFICO. That is one line of argument, yes. I don't think there is high risk as may appear in this. We looked into a number of LBO funds. The funds themselves are diversified. There are a number of LBO's that are going on within a particular fund, so if one fails, the fund doesn't necessarily fail.

We have not found any indication of failure in any of the funds we have looked at. When you compare that to the return, one might say that the return and the risks sort of balance.

Mr. DORGAN. Are you familiar with the term PIK's as it relates to junk bonds, payment-in-kind?

Mr. DELFICO. We have come across that term, yes, but we haven't reviewed junk bonds.

Mr. DORGAN. The reason I asked the question is there are a lot of techniques being used in the placement of high-yield instruments. Some instruments are zero coupons that defer interest well into

the future, while others have payment-in-kind features. Still there are others in which the interest is unable to be paid, and so they revert to an equity instrument in order to avoid default. This tends to freeze the default rate so that folks would testify and say there is less problem here than we thought, because there has not been substantial default. This is despite the fact they have used a little-known conversion technique under SEC law to convert a junk bond that can't perform into an equity instrument.

Some, of course, suggest it was an equity instrument all along masquerading as debt for the purpose of deductibility. That gets way away from our discussion.

Mr. Delfico, thank you very much. Let me ask the chairman, who has just come back from attending a caucus in the other room, if he has additional questions?

Chairman PICKLE. Thank you very much.

[No questions were submitted.]

Mr. DELFICO. Thank you, Mr. Chairman.

Next is Mr. Tom Donahue of the AFL–CIO.

We are pleased to have you. If you will please proceed, your entire statement will be made a part of the record.

STATEMENT OF THOMAS R. DONAHUE, SECRETARY-TREASURER, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS [AFL–CIO], ACCOMPANIED BY MEREDITH MILLER, EMPLOYEE BENEFITS SPECIALIST, AND ERNIE DuBESTER, LEGISLATIVE REPRESENTATIVE

Mr. DONAHUE. Thank you.

I am accompanied this morning by Meredith Miller, our employee benefits specialist of the AFL–CIO, and by Ernie DuBester of our legislative department.

Mr. Chairman, we are grateful for the opportunity to appear, grateful for the time you take in these hearings. We think that it is appropriate to take a hard look at the serious threats that LBO's pose for workers' pension benefits, security, and we have testified in a number of fora to it, as to the various effects of those LBO's.

That activity is still on the rise and the motor gauging of our economy is reflected in the rise of corporate debt from 34 percent in 1983 to 42 percent in 1988, the debt which we think threatened our power to produce and our power to compete in the world economy.

Mr. Chairman, the total damage of that takeover activity and LBO activity, although still on the rise, hasn't yet been assessed in terms of the total damage of the trend to workers' communities in our economy.

One small and preliminary fact is that we know that we have lost at least 90,000 jobs, 90,000 jobs of AFL–CIO union members have been stripped because of takeover and LBO activity.

In terms of the effect of that activity on our pension funds or the interactions of the two, Mr. Chairman, I would just note that our pension plans represent 43.5 percent of all the institutional holdings in this country. They currently represent about 24 percent of the equity markets and 15 percent of the total bond market.

Those pension funds are being adversely affected by LBO's in a number of ways. The pension benefits of certain employees are being reduced as a result of the LBO-related layoffs of employees.

The Department of Labor study with which you are familiar notes that on the average, such a worker would suffer a reduction of about 23 percent of the pension expectations that he or she might ordinarily have.

The reduced pension benefits are flowing from a reduction, devaluation of bond holdings in the leveraged company or the devaluated equity investments in the event of bankruptcy of the leveraged company.

And there is the prospect and the reality of reduced or discontinued benefits for workers who are still employed by leveraged companies but whose pensions have been terminated, and the excess so-called assets captured by the employer.

There is some data on the extent of pension involvements in LBO financing. I must say most of it obviously is fragmentary at this point.

The Department of Labor, as you have heard this morning, says that less than 2 percent of overall pension fund assets are involved in LBO activity, but I would note that the data is uneven and hardly definitive.

Pension plans we do know accounted for 15 percent of the junk bond market in 1987, and we know that at least 5 percent of the public sector pension funds and some number of corporate funds are investing in LBO equity funds.

There are risks associated with those investments which we think fall into three categories. The risk posed by financing such as the junk bonds and the LBO equity bonds; the risks which flow from the devaluation of the bond holdings in pre-LBO days; and the risks that are posed by the termination and the capture by the corporation of pension funds, the capture of those so-called excess assets.

The extent of pension fund assets in LBO's does not appear to pose a serious risk to a diversified portfolio, but there are a number of factors that could increase those risks for current and future LBO investments.

The junk bond and the equity fund investments are concentrated in a small number of private and public pension funds. In one of the State funds, 7 percent of that pension fund, over $1 billion is invested in junk bonds in one of the State public employees funds.

Obviously, a downward cycle in the economy might pose risks for those LBO investments. There are—these LBO investments are a relatively new financial arrangement, and it is my understanding that 95 percent of them, after all, have come about since 1982.

I am not sure that we have any adequate effect of their long-term prospects or effectiveness. The evidence on the relationship between LBO's and plan reversions is scattered, but it is beginning to mount.

The PBGC said in one study that only 7 percent of reversions over $1 million occurred within a year after the LBO. There is an SEC study about to be released which notes that one-third of all the major reversions took place within 1 year of the takeover event.

You have heard testimony this morning from the GAO Office study noting that in 40 percent of the LBO's that it sampled, the pension plan was terminated. We did our our examination. Ms. Miller did an examination of PBGC data on completed reversions over $1 million for the period from 1980 through September 1988.

Where the reason for the termination of the plan was given as being due to corporate reorganization, we found that there were 276 such reversions in that 8-year period, 15 percent of the total reversions which related to that corporate reorganization. And those reversions accounted for $1.4 billion and affected over 2 million plan participants.

Think what those figures tell us, Mr. Chairman. While the evidence is fragmentary and not all totally coherent, one study with the other, there is mounting evidence that the LBO operation has resulted in an alarmingly high number of pension plan terminations, and that subject needs the address of your committee.

We have supported and do support, Mr. Chairman, the enactment of legislation that would contain certain worker, job and pension protections in the event of LBO's and have testified in support of legislation that would slow the general range of LBO activity.

We have testified in support of your ending the tax deduction on the interest on debt used for merger activity as a principal step for this committee. We have supported legislation to strengthen the excise taxes on green mail and on golden parachutes.

We would support the Employee Pension and Protection Act which is before another committee and which has now been introduced which would affect some of the pension aspects of these LBO transactions.

Beyond that, we would support legislation in other committees, Mr. Chairman, to enhance shareholder rights and to provide ways in which we could ensure a higher degree of corporate accountability through shareholder reform.

In terms of confidential shareholder voting, one share, one vote for all classes of stock and greater access for non-management shareholders to the records of the corporation. We have made certain recommendations on the tender offer process, and we think that it is appropriate that your committee, Mr. Chairman, examine, as you are doing, the tax aspects of these matters.

And we are most anxious to work with you and your committee staff in any way we can to advance the project. I would be happy to try to address any questions you might like to ask, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Donahue. You have given us good testimony, and the committee is glad to have it. We will look it over in detail.

[The statement of Mr. Donahue follows:]

89-16

**TESTIMONY OF THOMAS R. DONAHUE, SECRETARY-TREASURER
AMERICAN FEDERATION OF LABOR AND CONGRESS OF
INDUSTRIAL ORGANIZATIONS
BEFORE THE SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON
WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES
ON THE
UTILIZATION OF PENSION PLAN ASSETS IN LEVERAGED BUYOUTS
AND RELATED TRANSACTIONS**

April 27, 1989

Mr. Chairman and members of the Subcommittee, on behalf of the 14 million working men and women who make up the 90 unions of the AFL-CIO, thank you for conducting this hearing. We feel it is vitally important both to union members and to the nation that Congress take a hard look at the threat leveraged buyouts pose for workers' pension benefit security.

LBO activity is still on the rise. Yet nobody has accurately assessed the total damage the LBO craze is doing, not only to the afflicted companies and their employees, but to whole communities. The increasing number of corporations carrying heavy debt threatens America's power to produce and compete in the world economy. The mortgaging of our economy is reflected in the jump of corporate debt from 34 percent in 1983 to 42 percent in 1988.

At least 90,000 members of AFL-CIO unions have been stripped of their jobs because of mergers, takeovers, and leveraged buyouts. In fact, leveraged buyouts are the largest single cause of unemployment among retail workers in America in the past few years. The largest employer of the United Food and Commercial Workers Union is now KKR--Kohlberg, Kravis, and Roberts, an investment firm specializing in leveraged buyout deals and not firms traditionally in the food or retail industry.

Leveraged buyouts also raise questions about how we can make corporate America more productive and accountable. We certainly cannot leave this job to corporate raiders whose actions threaten the long-term health of our economy because they are aimed not at long-term economic growth but solely at short-term profits. As major investors in corporate America, worker pension funds have a great stake in creating a corporate governance system that redirects failed corporate policies in a way that enhances the value and stability of the existing company and its workers.

I. PENSION FUNDS AND LBO ACTIVITY

By virtue of their large holdings in American corporations and their tempting sources of collateral for repayments of debt, pension assets play a varied and significant role in leveraged transactions. As the largest single group of institutional investors, pension funds account for approximately 43.5 percent of total institutional holdings, 24 percent of the equity market and 15 percent of the bond market.[1]

Still these numbers do not begin to suggest the harmful impact that leveraged buyouts may have on workers' pensions. Workers' benefits may be adversely affected in the following ways:

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[1]Testimony of Dr. Carolyn Kay Brancato before the Committee on Education and Labor, Subcommittee on Labor-Management Relations, U.S. House of Representatives, February 9, 1989, p.8.

1. Pension benefits may be reduced because of leveraged buyout related layoffs. The Department of Labor estimated that workers who change jobs experience on average a 23 percent reduction in the benefit they would have had they maintained one single job.[2] This pension benefit reduction translates into a savings for the leveraged company. These companies may also have terminated the pensions covering laid-off workers and increased their savings by recapturing so-called excess assets from overfunded pensions.

2. Pension benefits may be reduced because of devalued bondholdings in targeted companies and/or devalued equity investments in the event of bankruptcy of highly-leveraged companies or the bankruptcy of limited equity partnerships known as leveraged buyout funds.

3. Pension benefits may reduce or discontinue pensions for workers still employed by the targeted company as a result of the termination and reversion of pension fund assets to the employer to repay debt.

No study to date has estimated the total exposure of worker pension fund assets in LBOs.

Studies have shown, however, that even though the overall amount of pension fund assets invested in leveraged buyouts appear small -- less than 2 percent of total assets according to the Department of Labor -- pension funds accounted for 15 percent of junk bond financing in 1987 or $18 billion. Pension funds also indirectly invest in junk bonds through mutual funds and insurance companies, each of which held 30 percent in junk bonds in 1988.[3]

No definitive study exists on the amount of pension fund assets that are invested in leveraged buyout funds. These funds pool equity that provide the seed capital for LBOs. One survey of the top 200 pension funds reports that, in 1987, 22 funds invested $3.7 billion in LBO equity funds. This figure is expected to increase to $7 billion in 1988. It is also reported that 5 percent of public pension funds are invested in LBO funds.[4]

II. PENSION RISKS ASSOCIATED WITH LEVERAGED BUYOUT INVESTMENTS

While these investments may appear not to pose a significant threat to diversified portfolios, there are a number of factors that heighten the risk factor for leveraged buyout investments.

1. Both junk bond holdings and LBO fund investments are concentrated in a small number of private and

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[2]Pension and Welfare Administration, U.S. Department of Labor, Washington, D.C., The Effect of Job Mobility on Pension Benefits, July 1988.

[3]Testimony of David Walker, CPA, Assistant Secretary for Pension and Welfare Benefits, U.S. Department of Labor, before the House Committee on Ways and Means, February 2, 1989. For junk bond statistics, see Congressional Research Service, The Library of Congress, Pensions and Leveraged Buyouts, prepared at the request of the Subcommittee on Labor-Management Relations, Committee on Education and Labor, U.S. House of Representatives, February 7, 1989, Serial No. 101-B.

[4]Congressional Research Service, Pensions and Leveraged Buyouts, op. cit.

public funds, thereby increasing the risk for plan participants in those funds. Junk bond holdings are concentrated in 16 percent of Fortune 100 companies and 15 percent of state fund holdings. Only 6 percent of private funds and 5 percent of public funds invest in LBO funds.[5]

2. Many experts have warned that a downward cycle in the economy could intensify the risks associated with leveraged buyout investments. Higher interest rates could jeopardize the financial ability of leveraged companies to repay debt used to finance the LBO. To date there are few reported LBO bankruptcies. However, we must consider that 95 percent of all junk bonds have been issued since 1982.[6]

Some commentators have raised concerns about the larger impact that collectively, these debt-laden companies could have on the economy if interest rates rose precipitously.[7] No study to date has shown that survivor LBO companies are more efficient and more profitable and hence able to meet their pension obligations. In fact, some economists argue the difficulties in drawing such conclusions because the LBO market has changed so much over the past few years and because operational data once the company goes private, is rarely accessible.[8]

3. According to the United States General Accounting Office, LBO fund investments also pose a liquidity risk because "plan assets are committed to a limited partnership for as long as 10 or 12 years, and the partnership interest cannot be traded on the open market like stocks or bonds."[9]

4. In testimony before the Senate Finance Committee, Dr. Kathleen Utgoff, Executive Director of the Pension Benefit Guaranty Corporation (PBGC), expressed concerns

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[5]Testimony of Dr. Carolyn Kay Brancato, op. cit.

[6]Testimony of Ed. Durkin, United Brotherhood of Carpenters and Joiners of America, before the Senate Committee on Labor, Oregon State Legislature, April 1989.

[7]See, Max Holland, "How to Kill a Company: The Anatomy of a Leveraged Buyout," The Washington Post, April 23, 1989, pg. C1-2. This article profiles one of KKR's first leveraged buyouts of the Houdaille Company, and shows the company's eventual bankruptcy when rising interest rates combined with foreign competition. **However, not mentioned in the article is the fact that Houdaille Company terminated its pension plan in 1983 and took a $40 million reversion.**

[8]Testimony of Dr. Carolyn Kay Brancato, op. cit. In addition, KKR recently released a study suggesting that, on average, their leveraged buyouts enhanced profitability and employment of the leveraged companies. The KKR study has been criticized for its questionable methodology because it excluded data on job growth and research and development in subsidiaries and divisions that were sold after the buyout. Criticism of the KKR study can be found in both The Washington Post article mentioned in footnote 9 as well as in testimony of Ed Durkin, op. cit.

[9]Testimony of Joseph F. Delfico, Director of Income Security Issues, Human Resources Division, United States General Accounting Offices, before the Subcommittee on Labor-Management Relations, Committee on Education and Labor, U.S. House of Representatives, February 7, 1989.

about the impact of LBOs on the PBGC's liability:

> "If highly-leveraged companies are more likely to fail, then the PBGC will be asked to step in more frequently as LBOs increase. Even if LBOs do not increase the chance of failure, the distribution of assets to the shareholders in an LBO reduces the assets available to the PBGC as an unsecured creditor in the event of a bankruptcy".[10]

III. PENSION RISKS ASSOCIATED WITH BONDHOLDINGS IN LEVERAGED COMPANIES

Leveraged buyouts also have serious implications for pension funds with pre-LBO bondholdings. The devaluing of the bondholdings is related to the capital restructuring of the leveraged company which usually results in a ratio of 90 percent debt and 10 percent equity. Bondholders in the RJR Nabisco LBO experienced a 15-20 percent drop in value which sent shockwaves throughout the bond market.

The negative implications for pension funds is illustrated by the North Carolina Pension Fund which held $500 million of RJR bonds and suffered a $75 million loss in those holdings. Bondholders are not taking the RJR Nabisco buyout sitting down. Metropolitan Life Insurance Company, one of the RJR bondholders, has filed a lawsuit against RJR for the $40 million loss it sustained.[11]

IV. THE IMPACT OF LEVERAGED BUYOUTS ON WORKER PENSIONS OF LEVERAGED COMPANIES

One of the most serious abuses involving worker pension funds in takeover financing comes from employer terminations and raiding of so-called excess assets from single employer pension plans.

Pension fund obligations of leveraged companies are reduced or discontinued altogether when those leveraged companies terminate the workers' pension plans and recapture so-called excess assets. A study by the Securities and Exchange Commission, to be released in the near future, finds that one-third of all major reversions took place within one year of a takeover or takeover contest. Dr. Utgoff of the PBGC testified that an undisclosed PBGC report found that 7% of reversions over $1 million occurred within one year after an LBO.[12] Our own examination of PBGC quarterly data on reversions over $1 million found that from 1980 to September 1988, 276 reversions or 15% of all reversions affecting 2 million participants and worth $1.4 billion dollars, were associated with reversions that listed merger and acquisition activity as the reason for termination.

We believe that both the PBGC and the S.E.C. studies severely underestimate the number and asset amount of reversions related to leveraged or other takeover activity. Both studies fail to examine reversion activity before the LBO, termination

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[10]Testimony of Dr. Kathleen P. Utgoff, Executive Director, Pension Benefit Guaranty Corporation, before the Senate Finance Committee, U.S. Senate. January 26, 1989.

[11]Margaret Elliot, "No Turning Back for LBOs", Institutional Investor, March 1989, pp. 135-151.

[12]Dr. Utgoff, op.cit.

activity that occurred shortly after the one-year period, and termination activity that occurred in subsequent divestitures.

We believe that employers who terminate pension plans to skim off excess assets violate workers' ownership rights and breach a promise of pension protection. The Department of Labor estimates that workers in such situations lose an average of 45 cents for every dollar they would have received if the plan had not been terminated.

The adverse impact of takeovers on pension benefits was made clear in the Texaco buyout of Getty Oil Company in 1984, which involved serious pension abuses affecting members of Local 8-898 of the Oil, Chemical and Atomic Workers Union. Texaco terminated the Getty plan and raided $250 million from the 18,700 former Getty employees, substituting the inferior Texaco plan. As a result, employees who retired found that their pension benefits had not increased in value in the four years following the takeover. To add insult to injury the $250 million that Texaco took from the terminated plan was used to fight off several subsequent takeover attempts and not to improve workers' wages or working conditions.

Another example of pension abuse is the termination of the Pacific Lumber pension fund, which has been investigated by the Labor Department and the Securities and Exchange Commission.

Using junk bonds to finance the takeover of Pacific Lumber, a company named Maxxam directed a brokerage firm to buy Pacific Lumber stock from six pension funds. This action served to "park" the stock until Maxxam could buy it at a later date, thereby depriving the pension funds of the takeover profit. Maxxam then terminated Pacific Lumber's $80 million pension fund and took control of $50 million in so-called "excess assets," which it used to help finance debt rather than to improve workers' wages or working conditions. The chart in the Appendix outlines this complex case.

V. AFL-CIO LEGISLATIVE PROPOSALS FOR THE PRESERVATION OF PENSIONS IN THE LBO MARKET

The goal of the AFL-CIO is enactment of legislation which contains certain worker pension benefit protections and is aimed at slowing the spate of leveraged buyout activity. This legislative agenda includes the passage of The Employee Pension Protection Act (H.R. 1661 and S. 685) and the enactment of other tax and shareholder rights legislation aimed at stemming the tide of LBO activity.

Of great legislative priority to our affiliates is the passage of The Employee Pension Protection Act (S. 685, H.R. 1661), which contains basic pension protections for workers and retirees in the event of a reversion. Furthermore, this bill recognizes that workers and retirees have a right to share in so-called "excess assets" -- a right that financially cushions the blow of devalued pensions associated with reversions. It is our understanding that roughly 600 reversions are on hold as a result of the six-month moratorium imposed by the Treasury. This staggering number of pending reversions is a testament to the urgent need for this legislation. We are very interested in working with you, Mr. Chairman and members of the Subcommittee on this issue.

The AFL-CIO believes that the Employee Retirement Income Security Act (ERISA), combined with recent clarification by the Labor and Treasury Departments, provides adequate guidance for fiduciaries regarding their decisions on tender offers and proxy contests. Essentially the Departments stated that fiduciaries

are not automatically obligated to accept tender offers just because they exceed the market price. Fiduciaries are, obligated to review the economic merits of each investment, and weigh the return on investments with risks in consideration of the plan's portfolio and participant needs.

In previous testimony on this issue, we have asked the tax writing committees to end the tax deduction on interest on debt used for merger activity or to retire equity. This action would deter the mortgaging of our economy for business transactions that merely redistributes wealth from workers and bondholders to fee hungry investment firms while providing no identifiable social good. In addition, we have also asked the tax writing committees to strengthen the excise taxes on "greenmail" and "golden parachutes". Both suggestions essentially stem from the fine work done by you and this Subcommittee when investigating these issues in 1985.

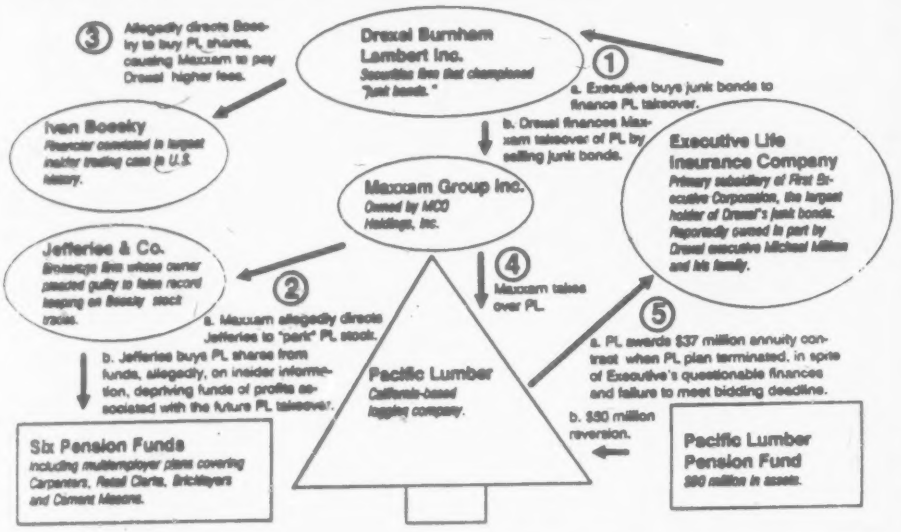
In other committees' jurisdiction we are concerned about the role of shareholder rights in corporate governance issues. Incompetent management and misdirected corporate policies resulting in undervalued companies and investor withdrawal have been exploited by corporate raiders in takeover activity. Efficient and accountable management, without the use of debt driven financing, could be achieved if Congress enacted shareholder reforms including: confidential shareholder voting, one share-one vote for all classes of stock and greater access for non-management shareholders to management proxy materials and records.

The AFL-CIO has also testified in support of certain changes in our securities laws before the committees of jurisdiction. We have advocated that the tender-offer or process should be improved by requiring that raiders provide workers and their communities with detailed disclosure about their plans for the new company, lengthening the time given to stockholders to respond to tender offers, and by prohibiting two-tiered offers. Of particular significance, in our view, would be an amendment to Section 16(b) of the Securities Act of 1934 to require that a raider, as well as corporate insider, disgorge any "short-swing" profits realized from the sale of stock acquired in connection with a tender offer and sold within a defined period of time after the offer expires or is withdrawn.

The AFL-CIO looks forward to working with you on these very important issues. Thank you.

The Pacific Lumber Takeover

The House Energy and Commerce Oversight and Investigations Subcommittee has uncovered evidence that major securities laws were violated during several corporate takeovers. Further, pension funds may have been cheated in these schemes, and Representative John Dingell (D-MI), who heads the subcommittee, has asked the Department of Labor to explore whether there has been violations of the Employee Retirement Income Securities Act. Concurrently, the Securities and Exchange Commission has charged securities violations in some of these same takeovers. Below is a diagram and chronology of the Pacific Lumber (PL) takeover, mentioned in both investigations, outlining allegations, including the pension connections.


3
Allegedly directs Boesky to buy PL shares, causing Maxxam to pay Drexel higher fees.
Drexel Burnham Lambert Inc.
Securities firm that championed "junk bonds."
1
a. Executive buys junk bonds to finance PL takeover.
Ivan Boesky
Financier convicted in largest insider trading case in U.S. history.
b. Drexel finances Maxxam takeover of PL by selling junk bonds.
Executive Life Insurance Company
Primary subsidiary of First Executive Corporation, the largest holder of Drexel's junk bonds. Reportedly owned in part by Drexel executive Michael Milken and his family.
Maxxam Group Inc.
Owned by MCO Holdings, Inc.
Jefferies & Co.
Brokerage firm whose owner pleaded guilty to false record keeping on Boesky stock trades.
2
a. Maxxam allegedly directs Jefferies to "park" PL stock.
4
Maxxam takes over PL.
5
a. PL awards $37 million annuity contract when PL plan terminated, in spite of Executive's questionable finances and failure to meet bidding deadline.
b. Jefferies buys PL shares from funds, allegedly, on insider information, depriving funds of profits associated with the future PL takeover.
Pacific Lumber
California-based logging company.
b. $80 million reversion.
Six Pension Funds
including multiemployer plans covering Carpenters, Retail Clerks, Bricklayers and Cement Masons.
Pacific Lumber Pension Fund
$80 million in assets.

Chronology

1. 6/24/85 - Maxxam begins buying PL stock. Drexel provides $480 million in junk bond financing, and a bank loan provides another $300 million. Executive Life buys some of those junk bonds.
2. 8/5/86 - Maxxam approaches $15 million holding threshold of PL stock that would require public filing and a temporary halt in further PL purchases. The next day, Jefferies begins buying 2.3% of PL's stock from sellers that include six pension funds, at below the market price, possibly on inside information, possibly in "parking" agreement with Maxxam. On 9/27/86, Maxxam buys PL stock from Jefferies, at a below-market price. Three days later, Maxxam announces intention to take over PL.
3. 10/1/86 - Drexel allegedly instructs Boesky to buy PL stock, boosting both PL's stock price and fees owed to Drexel by Maxxam.
4. 10/2/86 - Maxxam begins tender offer for PL. About three weeks later, Maxxam takes over PL. Drexel earns $41 million in fees. At this point, Boesky owned over 5% of PL's stock. After the takeover, PL accelerates tree felling, allegedly to reduce debt, angering employees and environmentalists. Employees also express fear about their jobs.
5. 3/31/88 - PL pension fund is terminated, with $80 million reversion going back to PL, to help finance debt. Executive Life is awarded $37.3 million annuity contract, over the objections of some PL executives, who argue that the firm missed the bidding deadline and holds risky investments, including junk bonds that financed PL takeover.

Sources: *Labor & Investments* diagram based on information provided by the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, October 5, 1987 Committee hearings, SEC lawsuit, and June 15, 1988 letter from Representative John Dingell to Assistant Secretary of Labor David Walker.

Chairman PICKLE. I noticed in the beginning you said that at least 90,000 members of the AFL–CIO union have lost their jobs because of these LBO takeovers, because of mergers, takeovers or leveraged buyouts.

That is a lot of people. If 90,000 of them have lost their jobs, have others been replaced? Has the company gotten stronger and other people been hired, or is it a net loss of 90,000?

Mr. DONAHUE. A net loss of 90,000 in those corporations have been affected by that takeover activity. I would note, Mr. Chairman, that those are AFL–CIO union members involved in such takeover activity. The number, obviously, for non-union employees affected under similar activity would obviously be much higher.

If we represent 37 percent of the work force——

Chairman PICKLE. Do you have any estimate of how much higher the figure might be?

Mr. DONAHUE. I am thinking close to half a million jobs affected.

Chairman PICKLE. A contention has been made——

Mr. DONAHUE. Jobs eliminated by that sort of activity. Now the question is as to whether or not there is replacement activity, similar type jobs are created in other corporations. I don't believe there is any data on that, Mr. Chairman.

Chairman PICKLE. The assertion has been made to this committee over and over that these mergers end up with a company being stronger and it creates more jobs in the long run.

Do you strongly disagree with that position?

Mr. DONAHUE. I would strongly disagree with it, Mr. Chairman, I would wait somewhat impatiently for conclusive evidence of that. I haven't seen any authoritative studies which show that all of this takeover/merger activity has resulted in a more efficient corporation or in higher employment for employees affected in those corporations.

Chairman PICKLE. The question of asset reversion is a sticky question, and a thorny question for us. We are trying to decide which way to go. There is a constant argument whether the benefits belong to the workers and retirees or to management since they basically take the risk.

The current law provides for these terminations. Now, I notice that there is legislation that has been proposed on the other side that would kind of reorder the current provision for distributing these excess assets.

I think the legislation pending would only affect overfunded plans and the question, of course, is where does the most harm come? To the participants or in other categories?

I don't know that harm comes to the participants per se. My question to you then is, When a company terminates a defined pension benefit plan in order to recover excess assets, does the greatest harm to the plan participants come from the termination of the plan or from the reduction of the assets in the pension plan?

Mr. DONAHUE. Well, Mr. Chairman, one of the problems of the overall subject as we have all discussed it is that we talk about asset recapture, reversion of excess assets. I start from the premise that the tax legislation which provided for pension plans and for the tax deductibility of contributions to pension plans, envisioned

that that was a transfer of assets from the corporation to a trust for the employees.

So I start from the premise that that money is in a trust for the benefit of employees. I don't think that the tax laws as this committee developed them were intended to provide an employer a place to park his assets tax-free and to enlarge them and then to recapture them and bring them back into the company.

Chairman PICKLE. We should keep in mind that the harm is not in the termination but in how you use the assets?

Mr. DONAHUE. No, I think the harm is in the termination. The effect of the pension plan, the desirability from a public policy standpoint, the question was should we have pension plans to provide retirement benefits for people?

And the entire thrust of the policies you have developed is to maintain those plans, not to terminate them. And when they terminate, there are adverse effects upon the participant employees.

Chairman PICKLE. Some members of our committee and some Members of Congress as a whole have been proposing that we prefund retiree health benefits, that we take these assets and then use them to prefund these plans.

Mr. DONAHUE. Yes.

Chairman PICKLE. In order to prevent the loss of benefits that can occur when a defined benefit plan is terminated and not replaced with a similar defined benefit plan, what would be your general reaction to the proposal to allow companies to withdraw excess assets from a pension plan without first terminating the plan?

Mr. DONAHUE. I start, Mr. Chairman, from the position that I would have to first define the excess assets. I don't know what they are. As currently defined by the corporation managing the trust, they are everything above the actuarial estimates to pay currently stated pension benefits if the plan were to terminate that day.

I believe that the—before you can call an asset excess, you have to determine that the plan has enough funds to pay out the normal expectations of the workers that that plan will continue to their retirement date.

That is to say, you have to provide enough assets in the plan to carry through a person's expectation of 20 years of employment, not the 10 at which point you decide to terminate the plan.

I think the suggestion that you take out, quote, so-called excess assets, and use them for prepayment of health benefits, is simply a dodge to find another way to excuse the capturing the assets from a pension plan and regard those assets as the property of the employer.

Chairman PICKLE. You oppose the use of these excess assets for retiree health prefunding purposes?

Mr. DONAHUE. Yes, I would.

Chairman PICKLE. Is that the position of the AFL–CIO?

Mr. DONAHUE. Yes, it is. Incidentally, Mr. Chairman, may I note? I can envision a circumstance in a negotiated pension plan where an agreement could be arrived at between the two parties in a negotiation to restructure or reorganize a pension plan.

I am addressing the area where the plan is where there is no one representing the interest of the employees. I think your committee has to do that.

Chairman PICKLE. Well, the AFL-CIO has consistently argued over the years that the workers are entitled to these excess assets and you ought to have them, and business argues that they are the ones that take the risk and funding the plan, it is their money.

The excess funds are theirs with the guarantee that the workers are entitled to a certain basic benefit based on the number of years and time he put into it.

Now, is the position of the AFL-CIO that the funds in these pension plans are really deferred compensation for the workers who participate in the plan or are they just deferred compensation?

Mr. DONAHUE. I have to believe that this is the only basis upon which this committee and the Congress would allow the employer to have the tax-deductibility of the contributions.

I cannot believe that the Congress ever intended that an employer could be taxed, have as tax-deductible a contribution to some sort of fund where he could park assets, manage them in such a way as to increase their value and then try to bring them back into the corporation.

I think they have to be regarded as deferred compensation, Mr. Chairman, and the property of the employees.

Chairman PICKLE. You are saying that the employees are entitled to these extra funds based on the principle that the assets are deferred compensation?

Mr. DONAHUE. Indeed, yes, sir.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Just a few questions.

Thank you, Mr. Donahue. What type of plan does the AFL-CIO have for its employees?

Mr. DONAHUE. A defined benefit plan.

Mr. SCHULZE. Is the plan underfunded or fully funded?

Mr. DONAHUE. The fund is quite adequately funded probably at about 75 or 85 percent level.

Mr. SCHULZE. So there are not excess assets?

Mr. DONAHUE. Well, I don't know. I would have trouble in defining those excess assets. I could tell you how we managed the funds. I am a trustee of the AFL-CIO fund. It was a fund of about $30 million 10 years ago when I became one of the trustees of it, and we brought in professional management and increased the availability to the fund of specialized advice.

And as a result of that, and as a result of continuing a very healthy rate of contribution, that rate is now at about $70 billion. As it has—$70 million, excuse me.

As it has increased, we have increased the benefits available under that plan to the extent that it is possible to do that. That, I think, is the approach that ought to be used in other pension plans where the fund, through careful management, increases its size.

And I think that that careful management and the proper husbanding of those funds ought to go to the benefit of the employees. That is how we operate the fund.

Mr. SCHULZE. Is it written that the employees are guaranteed that money?

Mr. DONAHUE. Very much so. It provides for the maintenance of this pension plan.

Mr. SCHULZE. No, upon termination, all of that money would go to the employees. Is that spelled out in the pension plan?

Mr. DONAHUE. Absolutely. I would be happy to supply you information on that.

Mr. SCHULZE. Mr. Donahue, that is what you are advocating, and if the AFL-CIO doesn't have it in their plan——

Mr. DONAHUE. I would certainly advocate it. I am hesitating only because I can't recall the language of our contract or plan. But there is no contemplation—first of all, I am sorry, we could not terminate our plan since it is a jointly trusteed fund.

So the management in this case, myself, as the management of the AFL-CIO and the other management trustees would not have the capacity to terminate that fund because we are an equal number of union and trustee representatives.

Mr. SCHULZE. Say the AFL-CIO merged with some other large union, and it were the dominant factor in the merger.

There is nothing in the plan that would cover such an incident?

Mr. DONAHUE. There is certainly nothing currently in the plan. If that arose, I would assume we would negotiate with the unions which represent our employees for an amendment of the plan or plans in order to provide the maximum benefit to the employees.

But we would, I assure you, use all of the assets for the benefit of the employees.

Mr. SCHULZE. I would be interested if that is written into the agreement.

Mr. DONAHUE. I am certain that it is not because we are the dominant labor organization and the dominant national center, and we didn't envision such a merger.

Mr. SCHULZE. How are your pension managers compensated? I don't know whether you were here earlier for the discussion that some actually receive a bonus.

Some get a percentage, if they get a higher income, they are going to be compensated in a better manner?

Mr. DONAHUE. No, our pension fund investments are managed by a national management firm, and their compensation is on a fixed percentage of the fund.

Mr SCHULZE. But it is a percentage and the higher they increase the income rate, the more they are compensated, so it is an incentive?

Mr. DONAHUE. Excuse me, Mr. Schulze. The compensation is on the size of the trust, not on the size of the income to the trust. If I could envision a year where we had a bad performance——

Mr. SCHULZE. If the income is $7 million one year, they don't get additional compensation. But the following year they would get additional compensation because the fund would be $77 million and, therefore, isn't there an incentive built in for them to get the highest return that they possibly can?

Mr. DONAHUE. Well, I suppose so. I suppose within reasonable limits and meeting sound fiduciary standards, the incentive is for them to increase the size of the fund. I would hope that that is the incentive of every fund manager.

Mr. SCHULZE. How do the pension benefits and plan compare with those in the private sector?

Mr. DONAHUE. How would our pension benefit plan? I think it is comparable. It is probably not as good a pension plan as—certainly not as good a pension plan as some corporations might provide.

It is probably on the order of percentile ranking, I would guess 75 or 80 percent in the ranking of pension plans. Since it is a negotiated plan, it would be higher than the average.

Mr. SCHULZE. Has your pension plan ever invested in any LBO's?

Mr. DONAHUE. Never. We have specific instructions to our fund managers not to invest in these kinds of securities or investments.

Chairman PICKLE. And you have not invested any of your funds in any LBO activity and you have put out——

Mr. DONAHUE. No, and we would specifically have specifically instructed our fund managers to that effect.

Chairman PICKLE. Pardon me.

Mr. SCHULZE. Mr. Chairman, go ahead.

Chairman PICKLE. Mr. Donahue, I am asking about your position on excess assets and whether you consider them as deferred wages, and you say that they are, and that, in fact, participants would be entitled to these funds.

What would be your position in the case of an underfunded plan? Would you say then that in that instance that the worker ought to have a reduced benefit claim if the underfunded plan is terminated?

Mr. DONAHUE. No. I think we have provided, have we not, Mr. Chairman, in other legislation for the funding requirements in ERISA to require rational funding of plans and provided through PBGC to cover that eventuality which might arise of the corporation on its pension fund responsibilities?

Chairman PICKLE. I try to look at the reasonableness of your approach. You say they are deferred wages and the assets all belong to you. But if one is underfunded, you say no, we don't want to consider them as deferred wages and so forth, and we let PBGC pick up the tab.

Mr. DONAHUE. No, Mr. Chairman. I would regard them philosophically. I would regard them as wages, and in other law, aside from a normal bankruptcy proceeding, we would certainly be a preferred creditor for the balance of that pension fund contribution.

We would certainly be entitled to be a preferred creditor in a bankruptcy procedure and our claims would precede lots of others.

So I think the analogy to the deferred wages continues in that situation of an underfunding, and if you ask me, where would I seek resort if a corporation defaulted, I would seek it first from the corporation, obviously, and the PBGC is intended only as an insurer of last resort.

Chairman PICKLE. Well, these are questions that I guess are ongoing, and it is indeed an ongoing controversy. This committee will be involved in expressing itself on our position on some of these asset reversion plans and legislation that is pending.

I think it is a legitimate question raised with LBO's and pension funds, and that is the purpose of this hearing, to find out first, have these LBO's actually caused unemployment and damage to the participants.

Your answer is yes, definitely. And you have 90,000 up to half a million. That is a factor we ought to examine closely and not just

take a bland assertion that this is something good, that these big mergers and acquisitions are indeed good for America. I feel that they are tax-motivated. At the same time, we have to examine the question of who has been hurt.

I also think we are losing sight of the fact that in these plan terminations and these asset reversions, that the value loss is from the termination and not what caused it or the result of the reversion.

Management and labor together make all these promises, you are willing to accept them, but you don't have to finance them, and the companies don't finance it sufficiently. We don't have enough safeguards. It is a weakness to this overall program, and we have to further strengthen these financial institutions. That should be understood.

Now, I know that you have opposed LBO's consistently, and I am impressed with your statement that you do not allow that union's pension funds to have been invested in any of the LBO's. And you say again that is correct, they have not.

Mr. DONAHUE. That is true as to the AFL-CIO's pension trust for our employees. That is the only one on which I have management authority, Mr. Chairman.

I would be very surprised to find that where unions have the power to effectively instruct investment managers, I would think you would find almost universally that they have instructed that investment manager not to invest in LBO's and in these LBO's activities.

Chairman PICKLE. And have they invested?

Mr. DONAHUE. We only know the percentages in gross terms of all pension plans. We don't have them separately for union pension plans, you see.

Chairman PICKLE. Well, that would be a matter of fact, and to the extent that you know it, you give us that information.

I thank you. I don't have any further questions at this point. I appreciate your testimony very much.

Thank you.

Mr. DONAHUE. Thank you, Mr. Chairman.

Chairman PICKLE. The Chair will ask the next panel to come forward; that will consist of Mr. Steve Schanes, Mr. David Feldman, and Mr. Howard Weizmann.

Mr. Steve—is it Schanes?

Mr. SCHANES. Schanes.

Chairman PICKLE. You represent the AARP, the worker equity volunteer division. Sarah Teslik is the executive director of the Council of Institutional Investors. David Feldman, which is Feldman in the center there, is the chairman of the Committee on Investment of Employee Benefits Assets. And is that out of AT&T?

Mr. FELDMAN. Yes, sir.

Chairman PICKLE. And then Mr. Howard Weizmann, representing the Association of Private Pension and Welfare Plans.

Mr. Schanes, we will ask you to proceed first.

STATEMENT OF STEVE SCHANES, WORKER EQUITY VOLUNTEER, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. SCHANES. Thank you, Mr. Chairman.

The AARP has submitted a written statement, and I will refer to that occasionally.

My name is Steve Schanes, and I am pleased to represent AARP today to discuss the impact of mergers and acquisitions on retirement security.

As to my background, I was the first Executive Director of the PBGC, and I am currently an employee benefits consultant. I was first Director of the New Jersey State Association of Pensions, and have been active in the welfare benefits field for 40 years.

I would like to focus my remarks on two issues involving pension plans: First, conflict-of-interest situations; and second, plan terminations for reversions.

Pension law requires that plan trustees act prudently and solely in the interests of plan participants. This duty, however, may become clouded, particularly in takeover situations.

Plan trustees, in their capacity as investment managers, must decide whether to hold or sell stock in which they have invested, and how to vote on various proposals affecting corporate control.

Plan trustees, however, often wear a second hat, that of plan sponsor or company officer.

Transactions that lead to changes in corporate control, particularly where large profits can be made, have increased the potential for conflict of interest. Our written testimony contains a number of examples.

In light of the recent wave of mergers and acquisitions, it is essential that the fiduciary duty of loyalty be affirmed. Plan trustees must act solely in the interest of plan participants. Therefore, where the potential for conflict exists, plan officials should seek independent disinterested advice, or temporarily step aside from the management of the trust.

A second major concern for pension plan security is pension terminations for reversions. As employers find themselves in need of ready cash, whether for fighting takeovers or retiring large amounts of debt, it is often employee benefit funds that are the source of needed funds. In particular, the buildup of pension assets in defined benefit plans has been a recent target.

Defined benefit pension fund reserve funding, coupled with better than expected returns on plan funds, has led to a large buildup in pension assets, estimated at about $200 billion more than is currently needed to satisfy benefit obligations.

Since 1980, over 2,000 large plans have been terminated totaling $20 billion in recaptured funds. A significant portion of these assets have played a major role in mergers and acquisitions.

Information that AARP has compiled on recent reversions, and the appendix of our testimony contains the details, indicates that 86 percent of companies with large reversions, over $50 million, have also been engaged in mergers and acquisitions. The total amount of pension reversions for these companies equaled almost $7 billion.

You should note that for companies with reversions over $10 million, over 40 percent have also been engaged in mergers and acquisitions. This finding is consistent with GAO's statements this morning.

AARP believes that terminations for reversions are harmful to the economic security of current and future retirees. The association has long urged restrictions on reversions, and has pointed to their use in takeovers as particularly onerous diversions of retirement funds.

AARP therefore recommends that reversions should be discouraged by, among other options, redefining "surplus" to more accurately reflect pension fund standards; encouraging the maintenance of pension plans with adequate asset "cushions"; requiring a "sharing" of reversion assets with employees and retirees; and prohibiting asset reversions in takeover activity, both offensive and defensive.

To conclude, AARP believes the recent wave of mergers and acquisitions has had a detrimental impact on benefit security. We hope to continue to work with this committee to pursue actions that will better ensure retirement security.

[The statement of Mr. Schanes follows:]

STATEMENT OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP) appreciates the opportunity to express its views on the use of pension assets in mergers and acquisitions, leveraged buyouts, and other related transactions. The Association believes the explosion of activity in this area, and the often adverse consequences for pension plan participants, is cause for great policy concern.

Background

The Employee Retirement Income Security Act (ERISA) was intended to protect the rights of participants and their beneficiaries under private pension, health and welfare plans. ERISA sets certain minimum standards for the protection of plan participants, particularly in the areas of vesting, participation, and funding. In addition, ERISA establishes a strict standard of conduct for plan fiduciaries -- those who have been empowered to administer and manage the assets in a plan. ERISA requires that a plan fiduciary act "prudently" and "solely in the interest of plan participants and their beneficiaries."

According to recent Department of Labor estimates, pension funds contain approximately two trillion dollars in plan assets. Other studies estimate that pension plans hold approximately 17% of all corporate stock and 7.5% of taxable bonds traded in the financial markets.

In addition, pension plans contain roughly $200 billion more than is needed to pay pension obligations currently owed to plan participants. While this so-called pension "excess" is not currently owed, much of the pre-funded amounts are intended to meet the future needs of current workers' pension expectations. However, since 1980, about 2000 healthy defined benefit plans have been terminated, with nearly $20 billion returned to plan sponsors.

Overview of Problem

Many believe that the recent surge of leveraged buyouts (LBO's) and the accompanying increase in indebtedness has put companies, and investors such as pension plans, at greater financial risk should the U.S. economy, or critical sectors, take a downward turn. Many of the firms that have been the targets of LBO's are major corporations. Many of the pension plans investing in LBO's are major pension funds. While a recession would of course put tremendous pressure on the entire economy, those dependent on these corporations, and those investing in these companies, would be particularly hard hit.

While pension plans themselves have invested in often very profitable takeover attempts, a conflict of interest may arise when pension trustees are also officers of the company. In this dual role, pension trustees may have interests other than the interests of plan participants, resulting in plan action not solely in the best interests of plan participants.

LBO's have often resulted in sold-off and closed-down plants or divisions, accompanied in many instances by terminated pension and retiree health plans, and other reductions in employee and retiree benefits. In effect, LBO's -- which have meant quick profits to the bankers, lawyers, and corporate managers -- have often been at the expense of taxpayers, employees, and retirees.

Pension Plans as Investors

In general, corporate takeovers involve changes in ownership or control of corporate assets. Because of the large amount of assets in pension plans, including significant stock and bond holdings, plan fiduciaries may become involved in corporate

takeovers in two ways: first, as investors of plan funds, and second, as fiduciaries who vote stock held by the plan.

During takeovers, pension plan fiduciaries, in their capacity as investment managers, must decide whether to hold or sell stock in which they have invested. In addition, they must also vote on various proposals affecting corporate control, including anti-takeover measures.

In recent years, pension plan assets have been increasingly invested in high-risk, high-yield bonds ("junk bonds"), often used to help finance takeover activity. One estimate has pension funds owning approximately 15 percent of the outstanding junk bonds, second only to insurance companies. Additionally, pension plans have committed to loan money to investors engaged in takeover activity and have invested in "pooled funds" whose specific purpose is to provide liquidity to engage in leveraged buyouts. In particular, some public pension funds have been among the largest investors in these transactions. These funds have contributed in part to the recent unprecedented liquidity in the market, which has prompted even larger deals.

Critics have already detailed the potential menace of the "leveraging" of corporate America. To the extent that the heavy use of debt threatens the financial system and the investments made on behalf of pension plan participants, the potential for economic loss during a recession or economic slowdown is greatly magnified.

Pension plan involvement (as investors) in takeover activity raises several concerns regarding risk and benefit security of plan participants. Thus far, however, it appears that pension fund investment in takeover related activity has not significantly threatened the plan funds themselves. A relatively small number of plans are engaged in such activity, and for these plans, only a small percentage of assets (generally about 2-3 percent) are at risk. Current law already recognizes a certain limit of risk permitted for pension investments. ERISA standards of "prudence" and "diversification", with proper enforcement, may be enough to prevent risk to the benefit security of plan participants.

While ERISA places certain restrictions on risk investments for private pension plans, other plans, such as public plans, may need additional standards. In any event, even small amounts of pension plan involvement means substantial money available for takeover activity. The question of whether tax-favored pension funds should continue to help fuel LBO's, however, is an issue that should be addressed within the broader context of problems associated with a high degree of leveraging. Legislation that merely denies or limits only pension plan investment opportunity would disadvantage these retirement vehicles (e.g. as against foreign investors) without addressing the basic questions raised by LBO's.

Pension Plan Fiduciaries: Potential for Conflict-of-Interest

Pension plan fiduciaries must make investment decisions solely in the interests of plan participants and their beneficiaries. In certain transactions, however, this duty may be clouded by other interests. In particular, plan fiduciaries in merger and takeover situations may face conflicts-of-interest when

choosing between their roles as plan sponsors and their roles as guardians of the interests of plan participants and their beneficiaries. Transactions that lead to changes in corporate control, when those involved have the most to lose and the most to gain, have exacerbated the potential for conflict of interest charges.

For example, when a corporation is threatened with a takeover

bid, a plan fiduciary must make decisions on the voting or selling of corporate stock, keeping in mind the "sole" interests of plan participants. However, when this fiduciary is also an officer of the corporation sponsoring the plan, the decision may inevitably be overshadowed by personal concern for one's continued employment or financial status in any new company. Fairness to plan participants in plan dealings is thus called into question.

The recent trend towards larger and larger mega-deals magnifies the fairness issue. The fact that management acts as both buyer and seller in the same transaction naturally raises the potential for misdealing. Large profits can be and have been made from transactions in which a company is bought and resold for substantial gains. In particular, these deals raise strong questions regarding fairness in the valuation of the initial purchase price.

Examples of Fiduciary Conflict-of-Interest

Fiduciary conflict-of-interest can be demonstrated through any number of examples. In one case, plan administrators had invested the plan's assets in the stock of corporations in which they were trying to gain control. In this instance, while both the plan and the administrators profited from the investments, an investigation ensued. The Department of Labor, in an amicus brief, stated that during a takeover struggle, a fiduciary should resign and a neutral trustee be appointed to manage the trust's assets. The court, while agreeing that this action was advisable, stated it was not required, but determined that in any event the plan administrators had not acted in the sole interests of plan participants. The court properly concluded that the plan administrators had violated their fiduciary obligations by investing plan assets to further their own interests.

In one current case (See Savage v. Federated Department Stores, No. 88-4444 (D. N.J.)) illustrating divided loyalties for fiduciaries, the trustees of a profit-sharing plan induced plan members to sell back to the company their shares of company stock held in the plan. At the same time, the trustees, who were also company officers, were engaged in discussions concerning several potential hostile purchasers. The aggressive stock repurchase program was targeted at employees age 55 and older. The trustees allegedly: (1) failed to inform these employees of the potential takeover bids; (2) failed to inform the employees of prior company action to purchase stock at prices above those quoted on the New York Stock Exchange; and (3) failed to inform the plan participants that the "break up" value of the stock had recently been estimated at a value significantly higher than that offered in the repurchase program. The stock repurchased by the company from its employees was resold six months later after the takeover was completed at a price nearly 50% higher.

This case, currently before the courts, illustrates again the potential for harm to plan participants from trustees wearing two hats -- that of plan fiduciary and that of company officer. In their role as company officers, the trustees had reason to want company ownership of outstanding stock to help fight off, or negotiate [illegible] hostility, the trustees also had access to information necessary to informed decision-making by plan participants. This information was not shared with plan participants, and indeed the trustees arguably counseled plan participants to act against their best interests merely to serve the interests of the company officers. In these instances, plan trustees are in a position where they may not act solely for the benefit of plan participants.

In another recent case (See Washington Post, 3/28/89, p. E-1), the Department of Labor brought suit against two former executives of Dart Drug Stores, Inc., alleging these officers

cheated the pension plan of $3.5 million when they bought the company. In essence, the suit alleges the two executives used pension fund money -- of which they were trustees -- to buy stock at a price over fair market value and at terms less favorable then those received by themselves and other investors. Using this difference in stock prices allowed the two executives to gain voting control of the company. This management-led buyout reportedly led eventually to near bankruptcy and a major financial restructuring.

Recommendations

In light of the potential for abuse in the inevitable circumstances of conflict-of-interest, it is important that the fiduciary duty of loyalty be reaffirmed in order to insure that plan participants are not harmed. Plan trustees must act solely in the interests of plan participants and their beneficiaries, and must avoid placing themselves in a position where their dual roles as officers of the corporation will prevent them from functioning with complete loyalty to the trust.

In short, where the potential for conflict and misuse of plan assets arises, plan officials should seek independent, disinterested advice. The fiduciary should therefore be required to either resign or temporarily step aside from the management of the assets of the trust. In addition, better clarification of fiduciary responsibilities, including voting procedures and disclosure policies, is necessary to insure the rights of plan participants.

Short-Term Cash Needs -- A Threat to Benefit Security

A second major concern of employees and retirees is the effect of increased merger and acquisition activity on benefit security. In particular, as employers find themselves in need of ready cash -- whether for fighting takeovers or retiring large amounts of long-term debt -- it is often employee benefits that are the source of needed money.

Termination of Pension Plans to Gain Access to Plan Funds

One source of ready cash that has been exploited in recent years is money in defined benefit pension plans. Under current law, a company cannot withdraw assets from a pension fund. However, the law allows a company to completely terminate a pension plan, pay benefits that were earned up to the date of plan termination, and recapture any assets that remain in the pension trust. There are no restrictions on the employer's use of these assets (although a 15 percent excise tax applies).

In general, these defined benefit plans are plans that promise a specific pension benefit upon retirement. The benefit amount is usually based on a formula involving number of years of service and salary. Because of this formulation, these plans tend to accrue benefits more rapidly in the later years of an individual's work life. In order to account properly for the build-up in pension benefits in the later years, companies generally are required to prefund their pension benefits in the early years.

This prefunding, coupled with better than expected returns on investment of plan funds, has led to a large build-up in pension funds beyond what is currently needed to satisfy the accrued benefits of plan participants. A recent study of Fortune 500 companies (using 1987 financial statements) indicated that 86% of companies had assets in excess of their accrued pension benefit obligations. While these funds will for the most part be needed in ongoing plans to meet future benefit obligations, they are considered "excess" on a current plan termination basis. In total, it has been estimated that the amount of pension fund "excess" on a plan termination basis

is about $200 billion.

Since these assets are a ready source of cash, the build-up of assets in defined benefit plans has become an attractive target. For example, Company A may take over Company B, then terminate Company B's pension plan, removing any pension funds not needed to pay plan benefits earned up to that date. These recaptured funds may then be used to help finance (i.e., pay off corporate debt) the original takeover. On the other hand, Company B, realizing it is the target of a takeover, may prematurely terminate its own plan in order to gain access to cash to help it fend off a takeover bid. Company B's termination of its own plan may also make it a less attractive takeover target.

Scope of Problem of Terminations for Reversions

The scope of pension terminations for reversions in this decade is alarming. Terminations for reversions were essentially unknown before 1980. Since that time, and through 1988, (according to Pension Benefit Guarantee Corporation (PBGC) information), nearly 2000 plan terminations with reversions of over $1 million each have been completed. The total amount of recaptured pension assets has now reached nearly $20 billion, and the number of plan participants affected by these terminations is over 2 million.

The General Accounting Office noted in a 1986 report that Congressional oversight was warranted because "many employers were terminating plans with excess assets because of a desire to use the excess assets for non-pension-related purposes, such as alleviating adverse business conditions or retiring long-term debt."

While legislative efforts to curb this abuse have made modest progress in the past few years, the threat to employee and retiree benefit security remains high. Generally, whether an employer establishes a new pension plan (and what type of plan) determines the extent employees are made worse off. Again, PBGC data on pending pension terminations as of September 30, 1988, is instructive. According to the PBGC, one-quarter of plan participants are in plans that have not established a new plan. In addition, one-half of plan participants are in plans which have created new defined contribution plans, plans in which investment risk falls on the employee. Only one quarter of participants are in plans in which the employee is generally best protected -- a reestablished defined benefit plan. (Even in these instances, the plan is bound to be far less well funded, since the "cushion" of assets that had been built up has now been stripped by the termination.)

In these terminations, annuities are generally bought to cover retirees' benefits. The practical result is that retirees are unlikely to receive any future pension adjustments. This contrasts with the latest Department of Labor information that suggests that nearly 40% of retirees have received some type of ad hoc pension adjustment to compensate for the loss of value in pension amounts over time.

While the incidence of reversions has declined from its peak in 1985, AARP believes the threat of terminations for reversions remains a serious problem. First, a number of companies have already taken reversions, suggesting that the decline is temporary because many have recently taken their "first bite" of the pension apple. Second, interest rates have again increased, which makes annuities cheaper to purchase, leaving more reversion assets in a plan termination. Third, Congressional action in the past few years has most likely inhibited some reversion activity. This includes various proposed restrictions which have not been enacted, but have likely caused uncertainty. (A Treasury Department letter from October 22 of last year, set to expire on May 1 of this year,

has put a temporary halt on granting termination letters for reversions.)

In addition, the Association believes that pension plan assets will continue to play a significant role in mergers and acquisitions. To the extent that the markets and corporate managers are preoccupied with cash flow, pension assets will remain a target.

Role of Reversions in Mergers and Acquisitions

To underscore the role that pension assets have played in mergers and acquisitions, it is instructive to review the activity that has taken place thus far. Using PBGC lists of companies that have completed terminations for reversions, and comparing them with companies that have been involved in merger and acquisition activity, suggests the extent of pension money involvement in these transactions. While it is difficult to trace the exact use of money recaptured from pension funds, the cross-match of companies highlights the current threat to participant's pension security.

Preliminary figures indicate a strong correlation between companies with terminations for reversions and those involved in mergers and acquisitions, particularly where large pension reversions are involved (See attached Appendix for listing of companies with pension reversions of $10 million and over, January 1, 1985 - August 31, 1988).

For the companies with the largest pension reversions (over $50 million recaptured by the employer) between January 1, 1985 and August 31, 1988, about 86% had also been involved in merger and acquisition activity. The total amount of pension reversions in this time period for these companies equals about $6.7 billion. For those companies with over $10 million in pensions reversions, over 40 percent were also involved in merger and acquisition activity. Of this amount, over 40 percent were LBO's. No doubt a portion of these recaptured pension funds played a significant role in non-pension related actions.

Recommendations

AARP continues to believe that terminations for reversions are harmful to the economic security of current and future retirees. The Association has long urged restrictions on terminations for reversions, and has pointed to their use in takeovers and acquisitions as particularly undesirable diversions of retirement funds for non-retirement purposes, and often for activities of questionable economic value. The Association has supported policies to discourage terminations for reversions and to provide protections for employees and retirees.

Terminations for reversions should be discouraged, and plan participant protection encouraged by, among other options:

* Redefining pension "surplus" to reflect more accurately current funding standards and the long-term needs of pension plans,
* Encouraging the maintenance or reestablishment of existing plans with sufficient asset "cushions"
* Requiring a "share" of reversion assets, originally intended for retirement security, to go to employees and retirees,
* Increasing excise taxes on reversions, and
* Prohibiting asset reversions in takeover activity.

Additional Harm to Employees and Retirees

While there exists some information as to the impact of mergers and acquisitions on pension security, there is even less information on other important aspects of employee and retiree security. Since leveraging creates the need for assets to

retire debt, a company may be forced to cut back on benefits it might otherwise have offered or maintained. For example, a number of corporate restructurings have also included the elimination or modification of important benefits such as retiree health benefits. These benefits are not currently guaranteed by federal law, although some courts have upheld retirees' rights to these benefits on a contractual basis. However, in the event the employer must divert cash to short-term needs, reducing funds for non-protected benefits such as retiree health benefits are another means to improve the short-term bottom line.

Other forms of economic dislocation may also be occurring, but they are again difficult to quantify. Many argue that plant-closings and large-scale layoffs are attributable to corporate need to generate greater cash flow to service debt. Such changes not only directly affect the individuals involved, but have repercussions in the community at large.

Conclusion

In conclusion, the Association believes the recent expansion of mergers and acquisitions, and increased corporate leveraging, has had a detrimental impact on benefit security. Some of the problems are a direct result of this activity, while other issues are broader problems that are exacerbated in the context of corporate takeovers.

As Congress addresses the broader questions of corporate debt and leveraging, it is also necessary to look at the component parts to better understand economic dislocation and the accompanying effect on individuals. AARP hopes to continue working with this committee to highlight problems, leading ultimately to action that will better ensure retirement income security.

APPENDIX

SUMMARY

CORRELATION OF MERGER & ACQUISITION ACTIVITY AND PENSION REVERSIONS FOR YEARS 1985 TO 1988*

ASSET REVERSIONS (in millions)	$10 - $49	$50 & Above	TOTAL $10 & Above
Total Number of Companies With Reversions	155	44	199
Number of Companies also Involved in Merger & Acquisition Activity (M & A) (including LBO's)	42	38	80
Number of Participants Affected	130,724	268,727	399,451
Percentage of Companies also Involved in M & A	27%	86%	40%
Total Asset Reversions of Companies Involved in M & A (in millions)	$1,094	$6,700	$7,794
Number of Companies Involved in Leverage Buyouts (*LBO's)	23	10	33
Percentage of Companies Involved in M & A Which Were LBO's	55%	26%	42%
Total Asset Reversions of Companies Involved in LBO's (in millions)	$607	$2,168	$2,775

*January 1, 1985 through August 31, 1988. This information is based on PBGC data of companies with reversions, and M & A data compiled from the SEC, stock research resources and a number of other sources as cited in the body of the Appendix. Because of the large and diverse nature of available data, this list is not necessarily exhaustive.

APPENDIX

CORRELATION OF MERGER & ACQUISITION
ACTIVITY AND PENSION REVERSIONS
FOR YEARS 1985 TO 1988a

REVERSIONS INVOLVING ASSETS OF $50 MILLION AND ABOVE

Chubb Corp.

Participants:	Date of Termination:	Reversion:
(Parts) 5786	(D.O.T.) 1/21/85	(Rev.) $88 m

1. Acquired Volunteer State Life Insurance in 1984.

Fireman's Fund Insurance

Parts: 6,895 D.O.T.: 3/18/85 Rev.: $103 m

1. American Express acquired Fireman's Fund Insurance. In 1985, American Express spun off the troubled Fireman's Fund property/casualty insurance division through public share offerings. (Financial Times, 9/12/85)

American International Group

Parts: 6387 D.O.T.: 4/5/85 Rev.: $71 m

1. Acquired Jurgovan, Blair in 1985.

American Express

Parts: 20,999 D.O.T.: 4/30/85 Rev.: $90 m

1. American Express was involved in numerous acquisitions during this period.

2. In Business Week (8/12/85, P.71), American Express was listed as one of the corporations which were terminating pensions and recapturing funds for acquisitions.

Crum and Forster, Inc.

Parts: 10,940 D.O.T.: 6/3/85 Rev.: $ 82 m

1. Acquired by XEROX in 1983.

United Airlines, Inc.

Parts:	D.O.T.:	Rev.:
5684	7/5/85	$124 m
1872	7/5/85	511 m
6782	7/5/85	254 m
591	7/5/85	73 m

1. Acquired Hertz in 1985.

2. United Airlines was listed in two articles which discussed companies terminating pensions and recapturing funds for mergers and acquisitions. (Washington Post National Weekly Edition, 7/15/85, P.20; Business Week, 8/12/85, p.71)

Stauffer Chemical

Parts: 2316 D.O.T.: 7/29/85 Rev.: $36 m
2482 7/29/85 Rev.: $84 m

1. Acquired by Cheesebrough-Ponds in March 1985. Cheesebrough-Ponds was quoted in Business Week (8/12/85, P.71) stating that it would use $100 million excess from Stauffer's pension funds to shrink the debt incurred in its $1.25 billion acquisition of Stauffer.

***b Marine Midland Banks, Inc.**

Parts: 12,551 D.O.T.: 9/3/85 Rev.: $95 m

1. SEC form 13E3C filed 12/16/87 and 11/17/87 by Marine Midland Banks.

2. Marine Midland acquired Mach. National in 1985.

***** Union Carbide Corporation**

Parts: 1920 D.O.T.: 9/30/85 Rev.: $504 m

1. Union Carbide was raided by GAF Corp. in 1985. This LBO takeover attempt was unsuccessful. As a result of the fight, Union Carbide incurred heavy debt. In 1986, Union Carbide began massive restructuring and paring down divisions. (Business Wire, "GAF-Letter to Union Carbide",-12/9/85)(Business Journal of New Jersey, March 1986, V.3, N.7, S.1,; P.74)

Phibro Saloman, Inc.

Parts: 735 D.O.T.: 9/30/85 Rev.: $53 m

1. Phibro tookover Saloman Brothers, then Saloman swallowed Phibro (Business Week, 6/4/84, P.114) The company was restructured as Saloman Brothers.

***** Amsted Ind., Inc.**

Parts: 2118 D.O.T.: 11/21/85 Rev.: $64 m

1. Amsted completed its LBO in June 1986. Management and its Employees Stock Ownership Plan acquired Amsted. (PR Newswire, June 3, 1986)

* FMC Corp.

Parts: 11,556 D.O.T.: 11/30/85 Rev.: $726 m

1. Boesky acquired an 8% interest in 1986.

2. FMC was burdened with junk debt and bank loans after a $2 billion recapitalization in 1986. This recapitalization had the characteristics of a LBO. An increase in earnings in 1987 was due to the restructuring of the pension plan. (Crain's Chicago Business, Oct. 26, 1987, P.38)

* TG&Y Stores

Parts: 15,138 D.O.T.: 12/1/85 Rev.: $50 m

1. A group of investors headed by Roger E. Strangeland, CEO of Vons Grocery, planned to acquire three chains from Household International including TG&Y Stores. (Supermarket News, 10/28/85, V.35, P.1)

2. Less than one week before the Dec. 31, 1985 completion of the LBO, Household International sold TG&Y Stores to Rapid American Corporation. (Crain's Chicago Business, 1/6/86, P.37)

Bunker Ramo Extra

Parts: 4475 D.O.T.: 12/20/85 Rev.: $84 m

1. Ing C. Olivetti acquired Bunker Ramo from Allied-Signal in 1986. (The Reuters Business Report, 2/8/89)

Westin Hotel

Parts: 212 D.O.T.: 12/30/85 Rev.: $52 m

1. Westin Hotel is a division of United Airlines which acquired Hertz in 1985.

* Levi Strauss & Co.

Parts: 23,473 D.O.T.: 12/31/85 Rev.: $25 m
4178 12/31/85 27 m

1. R. Haas acquired Levi Strauss in a LBO in 1985.

* Anderson, Clayton & Co.

Parts: 3433 D.O.T.: 12/31/85 Rev.: $77 m

1. Bear, Stearns & Gruss raided Anderson in 1986. Anderson decided to pursue a self tender offer and reject the Bear, Stearns & Gruss offer. To finance this self tender offer,

Anderson received bank financing and terminated two retirement plans. (PR Newswire, Aug. 15, 1986)

2. A deal which included a part leverage cash out and a part leverage buy-out was offered to shareholders by Anderson. (Forbes, 4/7/86, P.58)

Transco

Parts: 856 D.O.T.: 3/1/86 Rev.: $115 m

1. Leaseway acquired Transco for an undisclosed sum on 4/1/86. (Mergers and Acquisitions, Index of Buyers and Sellers 1986)

* **Pacific Lumber**

Parts: 3823 D.O.T.: 3/31/86 Rev.: $50 m

1. Charles E. Hurwitz and his company Maxxam Group tookover Pacific Lumber in February 1986. Hurwitz is often referred to as an investor who borrows heavily to gain control of a company and then "milks it of cash to finance his next deal." (Business Week, 2/2/87, P.64)

2. Over $18 million was recorded as a gain for Pacific Lumber from a pension plan termination in 1987. (Business Wire 8/14/87)

Dresser Industries

Parts: 18,532 D.O.T.: 4/30/86 Rev.: $124 m
765 4/30/86 6 m

1. Merged with Halliburton in 1986.

2. Dresser acquired Pleuger Unterwarrpumpen in October 1987. (Merger and Acquisitions, Index of Buyers & Sellers of 1987)

3. Dresser was involved in a series of acquisitions between 1986 to 1988.

* **NL Industries**

Parts: 8931 D.O.T.: 5/1/86 Rev.: $150 m

1. SEC form 13E3 filed by NL Industries on 4/29/86.

2. The takeover, by NL Industries, headed by Harold Simmons, cost about $156 million and was effective on 6/6/86. (Merger and Acquisitions, July/Aug 1986, P.69)

Baker International/Hughes

Parts: 12,467 D.O.T.: 6/9/86 Rev.: $56 m

1. Baker and Hughes merged in Jan. 1987 (The Economist,

8/15/87, P.61) The transaction was valued at about $816.3 million. (Mergers and Acquisitions, September/October 1987, p. 95)

* **Enron**

Parts: 2175 D.O.T.: 6/30/86 Rev.: $232 m

1. Enron acquired Houston Natural Gas in 1985 (Financial Times, 6/17/86, p. 30)

2. National Distillers & Chemical Co. acquired Enron on 11/5/86 for $570 million in cash plus the assumption of $34 million in industrial revenue bond debt. Total cost was $604 million. (Mergers and Acquisitions, March/April 1987, p. 10[illegible])

Exxon Corporation

Parts: 1500 D.O.T.: 8/12/86 Rev.: $1,600 m

1. Exxon spent $1.86 billion on acquisitions in 1987, and planned to spend more than $1.8 billion on acquisitions in 1988. (Reuters Business Report, 3/8/88)

2. In August 1987, Exxon purchased Celeron Oil & Gas for $650 million form Goodyear. (Business Wire, 8/10/87)

Penzoil

Parts: 8728 D.O.T.: 8/30/86 Rev.: $71 m

1. Penzoil failed in its bid for Getty in 1984.

* **Phillips Petroleum**

Parts: 11,160 D.O.T.: 9/1/86 Rev.: $400 m

1. Phillips Petroleum fended off raids from Pickens and Icahn.

Ashland Oil, Inc.

Parts: 13,000 D.O.T.: 1/2/87 Rev.: $165 m

1. Valvoline Oil, a unit of Ashland, acquired Rapid Oil change in 10/1/86. (Mergers and Acquisitions, Index of Buyers and Sellers of 1986)

2. Ashland paid greenmail to Belzbergs in 1986.

Morrison Knudsen

Parts: 5949 D.O.T.: 12/12/87 Rev.: $82 m

1. Expanded with real estate.

CBI Industries Inc.

Parts: 1323 D.O.T.: 12/31/87 Rev.: $55 m

1. GAF acquired a 9% share then suggested a raid in 1986.

Occidental Petroleum

Parts: 5811 D.O.T.: 3/15/88 Rev.: $95 m

1. In May 1988, Occidental Petroleum acquired Crain Chemical Inc. for $1.25 billion in cash. (Business Wire, 5/3/88)

Cabot Corp

Parts: 74 D.O.T.: 5/15/88 Rev.: $60 m

1. Maxxam Group Inc. is described in the Pacific Lumber case. Maxxam acquired a unit of Cabot Corp. on 6/30/86. (Mergers and Acquisitions, Index of Buyers and Sellers of 1986)

2. A stake was taken by GAF Corp in 1989.

Goodyear Tire

Parts: 13,100 D.O.T.: 6/30/88 Rev.: $400 m

1. Goodyear paid greenmail to Goldsmith in 1985.

2. Chairman of Goodyear wrote employees a letter discussing the attempted takeover and the restructuring plan. Also, he expressed concern over the resulting debt. Their primary concern was to reduce debt. (Goodyear Tire and Rubber: Chairman Mercer's Address to Employees, 2/23/87)

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a. January 1, 1985 through August 31, 1988. This information is based on PBGC data of companies with reversions, and M & A data compiled from the SEC, stock research resources and a number of other sources as cited in the body of the Appendix. Because of the large and diverse nature of available data, this list is not necessarily exhaustive.

b. * indicates the company was involved in an LBO.

c. 13E3 filing with the SEC indicates a LBO occurred.

APPENDIX

CORRELATION OF MERGER & ACQUISITION
ACTIVITY AND PENSION REVERSIONS
FOR YEARS 1985 TO 1988 [a]

REVERSIONS INVOLVING ASSETS OF $10 TO $49 MILLION

*[b] American Sterilizer Company

Participants: (Parts:) 2020 | Date of Termination: (D.O.T.) 1/24/85 | Reversion: (Rev.) $23 m

1. SEC form 13E3[c] filed by American Sterilizer Co, 1/18/85.

2. November 5, 1984 - Kelso, First Boston and American Sterilizer announced a merger agreement for the acquisition of American Sterilizer. The acquiring company, AMSCO, is owned by certain senior executive officers and key employees at American Sterilizer. Kelso & Co. is an investment banking firm specializing in arranging, structuring and obtaining the financing for LBO transactions through the use of ESOPs. (PR Newswire Nov. 5, 1984)

* Wickes Company

Parts: 6971 | D.O.T.: 4/20/85 | Rev: $41 m

1. SEC form 13E4[d] was filed 12/20/85 by Wickes Company.

2. Wickes Company failed in its hostile takeover attempt of Owens-Corning Fiberglass. (Ohio Business, Nov. 1986, P.54)

3. Wickes, Drexel and Boesky were involved in a takeover attempt of National Gypsum in 1986.

Wickes made three unsuccessful takeover offers in 1986 for National Gypsum. (Dallas-Fort Worth Business Journal, Aug. 31, 1987. Vol. 11, No. 2, Sec. 1, P.1)

4. Management-led group launched a LBO and later withdrew its offer to acquire Wickes. (The Financial Times, Oct. 15, 1988, Sec. 1, International Companies & Finance, P.12)

Diamond International

Parts: 4548 | D.O.T.: 5/2/85 | Rev: $12 m

1. SEC form 13E3 filed by Diamond International, 12/13/82.

ClevePak Corporation

Parts: 3943 | D.O.T.: 9/1/88 | Rev: $21 m

1. In 1983, Rock-Tenn acquired ClevePak for $40 million. (Business Atlanta, Oct. 1986, V.15, N.10 Sec.1, P.78)

2. ClevePak and Madison Management announced the merger agreement to acquire ClevePak. (PR Newswire 4/1/86)

- SEC form 13D[e] filed by Madison Management Group, 10/31/85.

3. ClevePak bought Interspace in 1981. (Indianapolis Business Journal, 1/16/89 V.9 N.41, Sec.1, P.1)

* Central Soya

Participants:	D.O.T.:	Rev:
788	8/2/85	$ 7 m
1275	8/2/85	26 m
1623	8/2/85	4 m

1. Shramrock Capital, wholly owned by the Roy E. Disney family, acquired Central Soya in a LBO involving $277 million in new debt.

- Debt, now at 89.5% of capitalization, represents a substantial financial burden. Central Soya announced plans to reduce debt with proceeds from divesture of its branded food and by a restructuring of its domestic pension plans. (Business Wire, July 23, 1985 and PR Newswire Aug. 27, 1985)

- "Central Soya took $50 million from overfunded pension plans to pay down debt." (Forbes, Oct. 6, 1986 "The Wrongful World of Roy Disney", p.82)

Smith International

Parts: 1895 D.O.T.: 8/31/85 Rev: $13 m

1. Involved in a lengthy fight for control of Gearhart Industries. (Business Week, Aug. 13, 1984, P.122)

- Called off its bid for 56% of Gearhart Industries. In exchange for $80 million, Smith International surrendered 5.3 million shares which were originally purchased for $163 million. (Business Week, Apr. 1, 1985, p.64)

Fairchild Industries, Inc.

Participants:	D.O.T:	Rev:
4973	8/31/85	$35 m
723	8/31/85	$5 m
5543	8/31/85	$3 m

1. Acquired the business of Comtech Data Corp of Scottsdale, Arizona. (PR Newswire Nov. 8, 1984)

2. Acquired interest in General Electric. (Mergers & Acquisition Index of Buyers & Sellers of 1987)

3. Acquired 50% of American Satellite Company.

* Chromalloy American Corporation

Participants: 1355 D.O.T.: 9/30/85 Rev: $10 m

1. SEC form 13E3 filed by Sun Chemical 11/26/86.

2. SEC form 13D filed by Sun Chemical, 6/23/86, 7/14/86, 9/15/86, 11/19/85 and Elliot Assoc. 7/14/86, 11/12/85

* Revlon, Inc.

Participants: 1345 D.O.T.: 12/28/85 Rev: $39 m

1. LBO by Panty Pride for $1.83 billion. (The Financial Times Nov. 2, 1985)

* Western Auto Supply

Participants: 5158 D.O.T.: 12/30/85 Rev: $29 m

1. On December 23, 1985, the sale of Western Auto Supply to Wesray for $30 million was completed. (Business Wire, Dec. 23, 1985)

2. Western Auto became highly leveraged when Wesray, a NJ investment firm (headed by former Treasury secretary William Simon) acquired it. (Discount Store News, Aug. 24, 1987, V.26, P.39)

* SCOA Industries, Inc.

Participants: 10,102 D.O.T.: 12/30/85 Rev: $43 m

1. Thomas H. Lee (LBO Specialist & President of Thomas H. Lee Co.) proposed a $637 million LBO. (Footwear News, Aug. 5, 1985, V.41, P.2)

2. Shareholders approve LBO. (Footwear News, Dec. 16, 1985)

3. $607 million debt incurred because of the LBO. (Discount Store News, April 14, 1986)

* Dixie Yarns, Inc.

Participants: 2422 D.O.T.: 12/30/85 Rev: $13 m

1. SEC form 13E4 filed on 5/7/85 by Dixie Yarns

* International Controls
(LBO possible)

Participants: 1468 D.O.T.: 12/31/85 Rev: $16 m

1. PBCC lists reason for termination as company merger.

2. Arthur M. Goldberg gained control of International Controls in August of 1985 by acquiring 21%.

- Goldberg and his partner Bear, Stearns and Co. acquired the remaining shares of International Controls and then used their assets to acquire Transway (Business Week, "Raider Goldberg tries Lowball Tactic, Dec. 16, 1985, P.79)

3. Merger with Transway complete (PR Newswire Dec. 27, 1985)

Freeport McMoran, Inc.

Participants: 3598 D.O.T.: 12/31/85 Rev: $39 m

1. Acquired Geysers Geothermal in Nov. 25, 1985. (PR Newswire Nov. 25, 1985)

2. FMP, affiliate of Freeport McMoran, announced plans to acquire oil and gas reserves owned by Earl P. Burke and Pel Tex Oil for $74 million. Closing was to occur prior to Dec. 31, 1985. (PR Newswire Oct. 3, 1985)

3. Freeport McMoran has an aggressive acquisition and selling

track during this time.

* SYBRON

Participants: 3223 D.O.T.: 12/31/85 Rev: $39 m

1. SEC form 13E3 was filed by Sybron on 1/29/86.

Pay 'n' Save Corporation

Participants: 6583 D.O.T.: 12/31/85 Rev: $15 m

1. Spirited takeover fight between Pay 'n' Save Chairman M. Lamont Bean and Schuck's Automotive Supply owners in 1984.

- Pay 'n' Save went private in 1984. (Pugent Sound Business Journal, Feb. 4, 1985 V.5, N.38, Sec 1, P.9)

* Gates Learjet

Participants: 322 D.O.T.: 1/31/86 Rev: $30 m

1. SEC form 13E3 filed by Integrated Acquisition, 9/23/87.

2. LBO by M.J. Rosenthal.

Beloit Corporation

Participants: 2059 D.O.T.: 6/30/86 Rev: $30 m

1. PBGC lists reason for termination as change of company ownership by sale or transfer.

2. Harnischfeger acquired Beloit for $175 million. (PR Newswire, Mar. 31, 1986)

3. Chairman Goessel of Harnischfeger talked of expanding Beloit presence in China. (The Business Journal-Milwaukee, May 19, 1986, V.3, N.31, S.3,P.8)

Gold Fields

Participants: 1311 D.O.T.: 6/30/86 Rev: $14 m

1. PBGC lists reason for termination as change of ownership by sale or transfer.

2. Sold US industrial interests in 1985 for $124 million to management group led by Richard Secust. (The Financial Times, 12/11/85, P.23)

3. Wholly owned subsidiary of consolidated Gold Fields, Inc. acquired by ARC for $242 million. (PR Newswire, Jan. 26, 1987)

Hughes Tool

Participants: 4256 D.O.T.: 8/31/86 Rev: $26 m
2041 8/31/86 $26 m

(See Baker International in list of asset reversions of $50

million and above)

* Becor Western

Participants: 3075 D.O.T.: 9/1/86 Rev: $41 m

1. A planned management-led LBO turned into a bidding war among several outside groups. (Crains New York Business, 7/6/87, P.3)

B. Altman

Particpants: 3100 D.O.T.: 9/1/86 Rev: $11 m

1. 1985, the Altman Foundation sold the company B. Altman to B.A. Realty which sold the retail operations.

2. Hooker Corporation acquired B. Altman & Company in 1987. (PR Newswire, November 6, 1987)

Reed Tool Company

Participants: 959 D.O.T.: 11/30/86 Rev: $21 m

1. Baker International owns Reed Tool.

- Reed Tool's reversion occurred around the same time of Baker/Hughes merger - (see list of asset reversions of $50 and above)

* Chicago Pneumatic

Participants: 130 D.O.T.: 12/1/86 Rev: $12 m

1. Cross and Trecker Corporation offered itself as a white Knight in its proposed acquisition of Chicago Pneumatic which was the object of a takeover bid. (Crains Detroit Business, Apr. 7, 1986, V.2, N4, S.1, P.1)

2. Danaker Corporation Tookover Chicago Pneumatic on Dec. 30, 1986. (PR Newswire December 30, 1986)

Commercial Credit

Participants: 1528 D.O.T.: 12/31/86 Rev: $25 m

1. PBGC lists reversion reason as a change of ownership

2. Acquired Resource Deployment, Incorporated (Business Wire, May 11, 1987)

3. Irving Trust acquired net assets of Commercial Credit Financial Services, Inc. (PR Newswire Apr. 2, 1986)

4. Merged with Primerica (Reuters Business Report, Aug. 29, 1988)

DoubleDay & Company

Participants: 4810 D.O.T.: 12/31/86 Rev: $28 m

1. PBGC listed reason for reversion as change of ownership.

2. Bertelsmann tookover DoubleDay in 1986. (Financial Times, July 14, 1987)

* Kelsey-Hayes

Participants: 3185 D.O.T.: 12/31/86 Rev: $ 29m

1. LBO in 1986 by Freuhauf Corporation.

2. Since the management-led buyout, the company has sold $855 million in assets and released 10,000 employees. (Business Week, Sept. 12, 1988)

Foster Wheeler

Participants: 4193 D.O.T.: 1/31/87 Rev: $25 m

1. Foster Wheeler is raided by Asher Edelman in 1987.

Alumax

Particpants: 3910 D.O.T.: 4/30/87 Rev: $26 m

1. Amax acquired Alumax for $355 million in cash funded by its cash balances and drawings from revolving credit agreements. (PR Newswire, Nov. 24, 1986)

* AMCA International

Participants: 5720 D.O.T.: 6/30/87 Rev: $39 m

1. As part of a LBO, three businesses were purchased from AMCA International Corporation. (Janesville Products, Osborn Manufacturing, and Jackson Buff) (PR Newswire, June 16, 1987)

* Asar Company

Participants: 4156 D.O.T.: 6/30/87 Rev: $49 m

1. SEC form 13E4 filed 10/6/87, 10/16/87 and 11/18/87 by Asarco.

Federal Pacific Electric

Participants: 1302 D.O.T.: 7/1/87 Rev: $21 m

1. Challenger Electric acquired Federal Pacific Electric in 1986 (Merger and Acquisitions, Index of Buyers and Sellers of 1986)

Foote Mineral Company

Participants: 503 D.O.T.: 8/31/87 Rev: $21 m

1. In April 1987, RTZ Borax was negotiating to buy Foote Mineral. (Financial Times, 4/10/87, P.24)

- Negotiations terminated on 5/6/87.

2. Merger with a subsidiary of Cyprus for $90 million. (PR Newswire, 12/15/87)

3. Raided by Pickens in 1988.

United Banks of Cal.

Participants: 550 D.O.T.: 9/1/87 Rev: $11 m
1100 9/1/87 $24 m

1. Acquired Intra West Bank in 1987. (Business Wire, Apr. 30, 1987)

Oneida

Participants: 3428 D.O.T.: 9/14/87 Rev: $15 m

1. Interest acquired by Oneida Ltd ESOP in 1987. (Mergers and Acquisitions, Index of Buyers and Sellers of 1987)

* Joy Technologies

Participants: 2400 D.O.T.: 9/25/87 Rev: $47 m

1. A management-led LBO of Joy Technologies in Fall 1986. (Financial Times, 7/31/87, P.20)

- High level of debt was incurred during the takeover. As a result, steps were taken to pare down its debt including: divestment of nonenergy assets and reductions in staff. As of August 1988, $400 million in total debt remained. (Pittsburgh Business Times and Journal, 8/29/88, V.8, N.2, S.1, P.1)

Emery Air-Freight

Participants: 881 D.O.T.: 10/31/87 Rev: $49 m

1. In 1987, Emery acquired Purolator Courier Corp. for an estimated total cost of $348 million. (PR Newswire May 12, 1987)

* CECO Corp

Particpants: 2005 D.O.T.: 11/13/87 Rev: $22 m

1. PBGC lists reason for termination as change of company ownership by sale or transfer.

2. In 1986, an LBO occurred.

* Moore McCormack

Particpants: 561 D.O.T.: 11/13/87 Rev: $12 m

1. PBGC lists reason for termination as change in company ownership by sale or transfer.

2. To escape an unsolicited tender offer by Southdown Inc., Moore McMormack considered a LBO by third parties. (PR Newswire, 3/16/88)

- Southdown acquired Moore McMormack. (Houston Business Journal, 9/26/88, V.18, N.15, S.1, P.12)

* National Gypsum

Participants: 1763 D.O.T.: 2/4/88 Rev. $11 m

1. AANCOR holdings acquired National Gypsum in a management-led LBO in 1986. (Fortune, 2/2/87, P.68) (The Reuter Busness Report, 10/6/87)

2. Wickes made three takeover attempts. Boesky, on Drexel's behalf, was helping Wickes arrange a National Gypsum takeover. (See Wickes on this list)

* Diamond Crystal Salt

Participants: 740 D.O.T.: 5/31/88 Rev: $13 m

1. SEC form 13E3 filed on 5/27/88 by DC Holdings.

2. DC Holdings, Inc. merged into Diamond Crystal. Diamond Crystal went private and the Moore family became owner of all outstanding capital stock. (PR Newswire 7/1/88)

Kentucky Fried Chicken

Participants: 990 D.O.T.: 6/30/88 Rev: $21 m

1. PEPSICO acquired Kentucky Fried Chicken for cash in 1986. (Fortune, 2/2/87, p.68)

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a. January 1, 1985 through August 31, 1988. This information is based on PBGC data of companies with reversions, and Merger & Acquisition data compiled from the SEC, stock research resources and a number of other sources as cited in the body of the Appendix. Because of the large and diverse nature of available data, this list is not necessarily exhaustive.

b. * indicates the company was involved in a LBO.
c. 13E3 indicates a LBO is occurring.
d. 13E4 indicates a company buy back.
e. 13D indicates someone is acquiring a 5% share.

Chairman PICKLE. Thank you, Mr. Schanes.

You were an official of the PBGC for a while.

Mr. SCHANES. First Director, yes, sir.

Chairman PICKLE. Your testimony has special meaning to it. Thank you.

Now we ask Sarah Teslik, executive director of the Council of Institutional Investors, to proceed.

STATEMENT OF SARAH A.B. TESLIK, EXECUTIVE DIRECTOR, COUNCIL OF INSTITUTIONAL INVESTORS

Ms. TESLIK. Thank you.

You have heard from others and from me before that pension funds invest relatively small amounts in LBO's and junk bonds in terms of the number of funds investing; in terms of the percent of their assets that they invest; in terms of the percent of total pension assets; and in terms of the percent of the total of all assets invested in such vehicles.

These facts speak volumes about pension investment practices generally. But even as fast as I speak, I can't do volumes in 5 minutes, so I will give you a few frames from the comic book classics edition. These comics are my own.

First, the obvious question. If pension funds are, as many claim, rabid short-termers who feel such pressure to outperform each other quarterly and who place such a premium on earning money now that they disregard the potentially harmful effects of such practices, why are so few pension funds putting so little money into LBO's and junk, which everyone admits have made a lot of money recently?

An obvious part of the answer: No group has less to gain and more to lose by investment practices that earn money now at the expense of more money later, or more harm to the economy later, than pension funds. There are at least two reasons for this.

One, the whole point of a pension fund is to maximize money that can be spent later, or at least to maximize money that can be spent on an ongoing basis. An investment that in fact produces money now at the expense of more money later would be an inappropriate, and indeed a potentially illegal, investment for most pension funds.

It is important to emphasize, too, that very large pension funds are not apt to make more money either now or later by having the kind of short-term focus that causes them to dart in and out of investments actively.

As numerous studies have now shown, pension funds are so big that they will, over time, be more affected by forces that affect the market generally than by efforts to scramble constantly a large chunk of it they call their own. This scrambling is expensive, there are transaction and market impact costs, so a pension fund would be crazy to pursue such a strategy if over time it does not produce additional gains to offset these costs.

Two, the second point is a little less intuitive. It may well be that even if pension funds could make more money by madly darting in and out of various bits of the market, they shouldn't, because they

can't put the money aside in the same way an individual can when saving for retirement. Here is why:

An individual can provide for retirement by putting money in the bank now which, with interest, can be spent in retirement. If individuals did this, there would be no need for pension funds. The problem is that individuals don't, or don't save enough, so pension funds were created to do the same kind of saving for them.

Part of policymakers' thinking was that, by providing tax-favored treatment and encouraging professional management, the Government could encourage collectively the kind of long-term planning and willpower that we lack individually.

This assumption may be unrealistic; it certainly gets less realistic the larger funds get and the more of the economy they own. Policymakers in search of money for current programs cannot realistically be expected to ignore large piles of money or a major chunk of the market. Witness the Social Security "surplus."

Current needs and current votes are real; future needs can only be guessed. Perhaps a pay-as-you-go system is the most that can be realistically expected from society.

The Economist suggests that those whose job it is to protect and provide retirement income should recognize these limits to society's ability, "preemptive capitulation," and recognize, in the face of these limitations, that the best way to ensure that pensions will be paid is to insure that there will be money in the economy generally to pay them, as well as money to meet other needs.

The best way to do that is to choose policies or investment strategies that are most apt to produce a healthy economy over the long term. In other words, even if money has not been officially set aside for pensions when the boomers retire, if the assets exist within the economy, ways will be found to pay pensions.

Conversely, legal rights to pensions will be meaningless if to pay them out would be too damaging to the rest of society. Legal niceties are meaningless if the wealth isn't there.

It is important to emphasize what this is not saying. It is not saying it is futile for fiduciaries to try to invent fund assets to make benefit payments possible in the future; it simply suggests that sticking exclusively to traditional investment functions may not be the best way to do so.

It is not saying that ERISA's exclusive benefit rule is now inappropriate and that fiduciaries should go charging after whatever other policies tickle their fancy; it simply suggests that to act effectively for the exclusive benefit of beneficiaries, fiduciaries must pick investment strategies most apt to have a positive, portfoliowide and marketwide long-term impact.

The point is, then, that the interests of large pension funds are in fact inseparable from the interests of the economy. Pension funds have no stake in creating rapid change or volatility for their own sakes.

Equally important, however, pension funds have a very big stake in making sure such change is possible, is cheap and efficient, and is driven by market forces. If a healthy, ongoing economy is critically important to pension funds, they must be free to use their market clout to help encourage it.

Having this interest does not necessarily mean staying committed to the same investments, or same investment vehicles for 30 years.

Let me give you one example:

> Council members are thus exploring new ways to give corporate planners the dependable long-term backing they need for long-term business planning in return for the accountability any shareholder would need for such a commitment.

Pension funds are thus looking for the best ways to keep their money in healthy businesses and to provide new money to promising new businesses. These are not only the best ways to ensure full employment, good jobs, and an internationally competitive economy, they are the best ways to protect pension assets.

A warning in closing: It is probably fair to say that the biggest threat to America's ability to pay pensions to all future generations, but especially the boomers, and perhaps the biggest threat to the performance of the economy generally is the potential that lawmakers and others will allow this increasingly large portion of the market to be driven by nonmarket forces.

This will happen if pension funds have defined for them what investments are deemed acceptable, what investment vehicles are deemed tastefully prudent, and what trading pace is deemed prudently gentile.

Rarely, if ever before, has a market economy had so many investors whose interests are so closely tied to those of the whole community. In the interest of the community, as well as in the interests of the pensioners, they should be allowed to pursue them.

Chairman PICKLE. Thank you.

[The statement of Ms. Teslik follows:]

Testimony By
The Executive Director of the
Council of Institutional Investors
Sarah A.B. Teslik
Before the Committee on Ways and Means
Subcommittee on Oversight
Hearings on the Utilization of Pension Assets
in Leveraged Buy-Outs and Related Transactions
April 27, 1989

The Council of Institutional Investors was formed to help its members fulfill their fiduciary obligations to increase the size and assure the security of their funds. At the time, forming such an organization seemed to many observers to be an unnecessary and quirky thing for fiduciaries to do. Traditional fiduciary investment functions -- allocating, buying, selling, voting, monitoring, and accounting -- were well understood and could be carried out without much communication with or cooperation from others. Pension fund fiduciaries were generally correct in believing that they fulfilled their obligations by carrying out these functions individually in the way they would if they were managing an individual's money, but on a larger scale. Fund security was not even an issue: pension assets were being tax favored, not taxed, and few serious efforts were being made by others to help themselves to a slice of the pension pie.

Times are changing rapidly, and, to quote Arthur Miller, attention must be paid to that fact -- particularly by fiduciaries held to a prudent expert standard. Whether by direct taxation or by mandating or denying specific investments, changing actuarial assumptions, taxing trades, lowering funding ceilings, or changing UBTI rules, state and federal policymakers and powerful constituent groups are increasingly diverting or spending pension assets for nonpension purposes. Protecting fund assets is thus rapidly becoming a -- if not the -- big priority for fiduciaries: there is no point in fussing over traditional investment strategies if the earnings simply get siphoned off.

An exclusive focus on traditional investment functions is increasingly inappropriate for another reason as well. The larger a fund gets the less it will be able to improve returns by limiting itself to refining its traditional investment functions. This is not just because transaction and market impact costs rise with size: funds are now large enough that they are and must remain in every market sector. They will thus inevitably be more affected over time by forces that affect the market generally than by efforts to dart in and out of specific portions of it. The larger a fund becomes the less appropriate it is for its fiduciaries to model their behavior after that of trustees of a small trust fund.

Fortunately, the kind of supplemental activity most apt in this new environment to add value to the funds is also the kind of activity most apt to protect them as well. The point is a subtle

one that requires a brief explanation.

An individual can provide for retirement by putting money aside now, which, with interest, can be spent in retirement. If individuals did in fact do this there would be no need for pension funds. The problem is that individuals don't, or don't save enough, so pension funds were created to do the same kind of saving for them. Part of policy makers' thinking was that, by providing tax-favored treatment and encouraging professional management, the government could encourage collectively the kind of long-term planning and willpower that was lacking on the individual level.

This assumption may be unrealistic; it certainly gets less realistic the larger funds get and the more of the economy they own. Policymakers in search of money for current programs cannot realistically be expected to ignore large piles of money or a major chunk of the market. Witness the Social Security "surplus." Current needs and current votes are real; future needs can only be guessed. Perhaps a pay-as-you-go system is the most that can be realistically expected from society.

This should be a modestly scary thought for babyboomers (and for your Executive Director, who, if this is all pointless, should resign). The Economist suggests that those whose job it is to protect and provide retirement income should recognize that there are limits to society's ability to save ("preemptive capitulation") and recognize, in the face of these limitations, that the best way to insure that pensions will be paid is to insure that there will be money in the economy generally to pay them (as well as money to meet other needs). The best way to do that is to choose policies or investment strategies that are most apt to produce a healthy economy over the long term. In other words, even if money has not been officially set aside for pensions when the boomers retire, if the assets exist within the economy, ways will be found to pay pensions. Conversely, legal rights to pensions will be meaningless if to pay them out would be too damaging to the rest of society. Legal niceties are meaningless if the wealth isn't there.

It is important to emphasize what this is not saying. It is not saying it is futile for fiduciaries to try to invest fund assets to make benefit payments possible in the future: it simply suggests that sticking exclusively to traditional investment functions may not be the best way to do so. It is not saying that the exclusive benefit rule is now inappropriate and that fiduciaries should go charging after whatever other policies tickle their fancy: it simply suggests that to act effectively for the exclusive benefit of beneficiaries, fiduciaries must pick investment strategies most apt to have a positive portfolio-wide and market-wide long-term impact.

Understanding this -- that pension funds' interests are truly inseparable from those of the country's economy generally -- should make it easy to understand the silliness of those who warn of the evils created by the size and investment strategies of pension funds. Virtually every market evil has been blamed on pension funds, but the most common allegation is that pension funds are legally and psychologically driven to ignore long-term performance. The claim is that funds focus exclusively on outperforming the market in the short term (clinically known as "*myopia quartalia hysteria*"). Such behavior, in turn, is said not only to fuel M&A activity, LBOs, and the junk bond market, and but to prevent corporate long-term planning, damage international competitiveness, cause job losses, and break up communities.

These allegations of rampant short termism would be funny if they weren't so dangerous. As the foregoing discussion has attempted to explain, no one has a bigger stake in acting in the best interests of the economy and its corporate constituencies -- generally and over the long-term -- than those who increasingly are the market. There is no free lunch. Pension funds and pensioners lose if they take profits now, and, as a consequence, a company or an industry or the economy performs badly later. No one has more to gain by responsible long term market behavior than pension funds.

The suggestion that ERISA prevents such an outlook is equally silly. ERISA doesn't require a short-term focus -- period. It is interesting that those who make such a claim never cite ERISA sections, regulations, or opinions to back it up. ERISA does specify one investment time horizon -- fiduciaries are to invest so that the funding obligations of the plan can be met. In the vast majority of cases these obligations are on-going, and hence, long term. Thus, for most funds, investing to make money now at the expense of making more money later would be more apt to be a breach of one's ERISA obligations than a satisfaction of them.

Council members' turnover and holding period figures demonstrate that they recognize that their interest in both individual corporations and the market is ongoing. Council members are working with policymakers and corporate representatives to clarify these misperceptions, to emphasize the importance of protecting pension assets, and to make clear that while managements and pension funds have similar long-term interests, pension funds cannot and should not attempt to secondguess most management decisions. Council members are thus exploring new ways to give corporate planners the dependable long-term backing they need for long-term business planning in return for the accountability any shareholder would need for such a commitment.

This kind of activity takes coordination and communication

-- services provided by the Council. Fiduciaries who ignore activities like these may think they are limiting themselves to essential investment activities when they are in fact doing precisely the opposite.

Chairman PICKLE. Mr. Feldman.

STATEMENT OF DAVID P. FELDMAN, CHAIRMAN, COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS, FINANCIAL EXECUTIVES INSTITUTE, AND CORPORATE VICE PRESIDENT, INVESTMENT MANAGEMENT, AT&T

Mr. FELDMAN. Thank you, Mr. Chairman. I am pleased to be here today, and I appreciate the opportunity to participate in these proceedings.

I am David Feldman, corporate vice president—investment management, for AT&T. I am speaking here today as chairman of the Financial Executives Institute's Committee on Investment of Employee Benefit Assets [CIEBA], as it is called.

CIEBA is an association of corporate benefit plan sponsors with 40 regular members and about 150 advisory members. We manage more than $450 billion in assets to secure retirement income for more than 6 million plan participants. Our perspective is that of those charged with fiduciary responsibilities under ERISA.

My remarks, and our more detailed written testimony, focus on how LBO's and other similar investments work as a part of a pension investment portfolio, and why they can be prudent and advantageous investment choices for our plan participants.

We believe that recent evidence speaks well for the private retirement system as it is currently structured: Benefits are quite secure in the aggregate, and the pension system, including both private and public plans, has become a significant source of institutionalized savings.

We don't believe that there is a problem on the investment side of the private pension system that needs to be fixed, with regard to LBO or any other investments.

First, corporate plan sponsors already operate within an effective framework of legal oversight and economic checks and balances.

Second, investments are diversified across a wide variety of asset classes in order to be well-positioned for and protected against as many economic circumstances as possible.

And third, pension investments in LBO's, the focus of the discussion here today, do not endanger benefit security. While individually these are higher-than-average-risk investments, they also provide a high level of expected return. As a small proportion of a well-designed portfolio, they generally serve to increase the overall return to the fund without inordinately increasing the overall level of risk.

A recent survey of our membership found that only 1 percent of total assets are invested in LBO-type funds. Even total losses in all such investments would not jeopardize benefit security. Our survey also found that only 1.3 percent of total assets are invested in publicly-traded high-yield bonds.

Opinion is divided within CIEBA as to a broader view of the economic implications of LBO's, but we are generally united on two fronts.

First, individual fiduciary decisions about whether or not to invest in LBO's are carefully and thoughtfully made. Considerations include: Fit with the existing portfolio, the prospects for the

particular investment being considered, and the fiduciary's views about the broader and longer-term implications of the individual investment or the investment class as a whole.

We do our best to focus on the overall balance of outcomes as they affect the security and earning power of our investments. We believe that focusing only on shorter-term gains would be a disservice to our fiduciary duties over the long term. We are long-term investors.

Second, we believe that LBO's are only one manifestation of more fundamental economic trends in the country today. The issues are extremely complex, and more time is needed for the underlying economic forces to surface. We urge extreme caution in crafting any legislation. Inadvertent side-effects could have serious and far-reaching impacts on our economy.

Moreover, legislation carries with it the added risk of creating distortions in the markets and hampering their ability to self-adjust which, we feel, has already begun to happen.

We also believe that the investment flexibility provided under ERISA is vital to ongoing success. This flexibility allows investment policies to evolve with the markets rather than prescribing a stagnant list of approved investment options. Freedom of action is essential if we are to successfully compete in today's rapidly changing worldwide markets.

Thank you.

Chairman PICKLE. Thank you, Mr. Feldman.

[The statement of Mr. Feldman follows:]

TESTIMONY OF
THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS
OF THE
FINANCIAL EXECUTIVES INSTITUTE

April 27, 1989

INTRODUCTION

These observations are presented by the Committee on Investment of Employee Benefit Assets (CIEBA), which is a committee of the Financial Executives Institute (FEI).

The FEI is an association of approximately 13,000 financial executives representing some 7,000 American corporations. CIEBA itself has 40 regular members and approximately 150 advisory members, all of whom are corporate ERISA-governed benefit plan sponsors with collective assets that total more than $450 billion.

The corporations represented in CIEBA cover a broad range of industry groups and asset size. However, it is important to note that CIEBA members - who manage their plan assets on behalf of more than 6,000,000 union and non-union plan participants - speak from the vantage point of those charged with fiduciary responsibilities under ERISA.

These comments are presented to the Subcommittee not to address the specifics of potential legislation, but to provide some background on the investment of pension fund assets and to comment on related issues under investigation by the Subcommittee. Although there are tax policy issues currently being debated that cause us concern, owing to their potential impact on the capital markets, we defer in those discussions, to the extent that they are not related to pension funds, to others with more expertise in tax policy. (The FEI has two such groups, the Committee on Taxation and the Committee on Corporate Finance.)

PENSION FUNDS AND THE U.S. RETIREMENT SYSTEM

We believe that, as currently structured, operated, and regulated, the retirement system in the U.S. has been on balance quite successful in securing retirement income for U.S. workers. It has remained healthy through the best and the worst of times in the financial markets and in the world for fifty years and more, in some cases, and benefits are more secure today than ever before. It is estimated that the aggregate private plan asset to liability ratio stood at 1.38:1 in 1987, and only about 17% of private plans are estimated to have been funded at less than 1:1 in that year.[1]

This mark of success can be attributed to a number of factors: the tax law which allows assets to accumulate without a tax burden; healthy financial markets over the past several years; and prudent asset management and funding strategies on the part of plan fiduciaries, working under the governance of ERISA since 1974. Besides establishing standards for investment practices, ERISA wisely, in our opinion, gives plan sponsors the flexibility to have investment policies that can evolve with the markets, subject to prudent expert tests. As a result, sponsors have been able to enhance fund returns and improve diversification by investing in a broad range of financial instruments and investment opportunities, some of which did not exist in 1974 when ERISA was crafted.

In addition to its achievements in securing benefits, the pension system, including both private and public sector retirement plans, has become the single largest source of institutionalized savings in the U.S. today. Despite a savings rate in the U.S. that compares unfavorably with other industrialized nations, the pension system has continued to be a growing and dependable source of capital for investment in the economy.

Few countries in the world place the retirement income burden so heavily on the private sector as does the U.S., and thus far, the results speak eloquently for caution in considering any changes. We urge the

[1]Source: Employee Benefits Research Institute

Subcommittee to proceed with that thought in mind, and to be alert in addressing broader revenue or tax policy questions to the unintended implications for pension funds, in terms of both benefit security and general economic efficiency. Particular care should be taken to guard against unintended consequences or hardships for defined benefit plans, which are generally held to be most beneficial to participants.

CURRENT SYSTEM OF GOVERNANCE, OVERSIGHT AND REGULATION

Corporate plan sponsors operate within a system of economic checks and balances that goes beyond the essential legal framework. It is created by the economic nature of the pension system itself. Corporate plan sponsors understand that economic prudence, not just legal prudence, on behalf of both the plan participants and the corporate shareholders, requires a careful and continuous assessment of the tradeoffs between the opportunity to reap investment gains and the risk of loss.

In defined benefit plans, the sponsor has a legal obligation to deliver a promised level of benefits to the participants. These benefits are paid for by a combination of corporate contributions and the earnings on the investment of those contributions, although the *obligation* to pay benefits is independent of the level of fund assets and earnings thereon. Employees generally do not make contributions to defined benefits plans. In 1987, defined benefit plans comprised approximately 27% of private plans, but accounted for 66% of trusteed private plan assets and, in 1985 (the most current data available), covered 72% of private plan participants.[2]

The plan participants and the corporate shareholders both benefit from investment policies aimed at maximizing pension fund returns subject to prudent risk-taking. For participants, higher fund earnings increase the security of benefits, and create less reliance on the corporation's ability to make future contributions. For shareholders, higher earnings reduce the amount they will ultimately have to pay to support a given level of benefits, and increase the dollars available to reinvest in the company's growth or to pay dividends. This, in turn, can help American companies in the aggregate be more competitive globally.

Similarly, participants and shareholders alike have a stake in controlling pension investment risk. If the value of contributed assets is decreased by investment losses, the participants will have to depend more heavily on future corporate contributions to secure their benefits. The shareholders will be required to pay more to deliver promised benefits, possibly detracting from the company's competitive position. *Ultimately, it is the corporation and thus the shareholder - not the participant - who bears the risk of inadequate returns or investment losses in a going concern's defined benefit plan.*

Many companies provide both defined benefit and defined contribution plans; some offer only one or the other. In a typical defined contribution plan, both the plan sponsor and the plan participants contribute specified amounts to the pension fund, and the earnings on those contributions are the only additional funds available for paying benefits. The participant, therefore, again stands to benefit from investment strategies aimed at maximizing return and controlling risk. The shareholder, although he has a less direct stake in a defined contribution plan than in a defined benefit plan, has an interest in prudent asset management because significant losses or relative underperformance would undoubtedly cause problems with employee welfare, morale, and productivity.

Aside from these economic considerations, which provide the strongest incentive for prudent asset management, it has been our experience that the overwhelming majority of pension plan managers live responsibly within the rules of all applicable laws and standards. In addition, through organizations such as CIEBA, most pension fund managers are proactive in their efforts to foster and maintain ethical standards. Since the enactment of ERISA, abuses by corporate sponsors have been rare.

ERISA is the major form of legal oversight for private pension funds. ERISA is jointly enforced by the DOL and the IRS, and is explicit in its requirements for prudence in asset management. In Section 404, the prudent

[2]Source: Employee Benefits Research Institute

man standard has been interpreted and applied as a prudent expert standard, requiring that a fiduciary "shall discharge his duties . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[3] This is a higher standard than other corporate/security laws, which only require that there be no negligence or gross negligence. ERISA also prohibits certain transactions (Section 406); for example, it has very strict and well-defined rules governing the financial transactions of the plan with the corporate plan sponsor. In addition to ERISA, pension funds, like any investor, are subject to various reporting and other requirements of most federal and/or state securities laws.

In addition to the economic and legal incentives for prudence, there are significant checks and balances in place in the current system.

First, checks by independent institutional fiduciaries are an added assurance that prohibited transactions do not occur. Assets must be held in trust, most commonly by a trustee bank (except for insurance contracts held by insurance companies), and to make an investment or withdraw funds, the plan management must direct the trustee to carry it out. The trustee has a legal obligation to check for prohibited transactions because it is a co-fiduciary. In effect, in order to misuse the plan assets, a plan sponsor would have to have the consent and knowledge of the trustee and the money manager involved.

Second, there is typically a committee of the board within the sponsor corporation charged with oversight of the pension plan management. Such committees exist in approximately 92% of companies affiliated with CIEBA, according to our recent member survey.

Third, private plans are audited by independent public accounting firms, and typically also by internal audit staff.

Finally, the Department of Labor audits a sample of private funds each year. The DOL has also been aggressive in policy-making and in using moral suasion to ensure the proper discharge of fiduciary duties on such issues as proxy voting and directed brokerage.

INVESTMENT OF PLAN ASSETS

ERISA requires that fiduciaries discharge their duties "solely in the interest of the participants and beneficiaries" and "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan".[4] This requirement means that plan fiduciaries must make investment decisions to provide the best possible assurance that the pension promise will be honored; therefore, the overall fund return should be maximized subject to a prudent level of risk. The appropriate level of risk is determined by a variety of factors, including the plan's projected payout obligations, the extent to which assets already in the fund cover projected liabilities, and the ability of the corporation to make future contributions.

In the investment process, the first and most fundamental decision made is the asset allocation decision, or what proportions of the fund should be invested in various asset classes such as stocks, bonds, real estate, etc. The allocation decision is based on analysis of the risk/return characteristics of alternative investments, the correlations among their return patterns, the fund's liquidity needs based on anticipated contributions and payouts, and other factors. *The risk of the total portfolio is reduced by diversifying investments among and within asset classes, because judicious diversification serves to partially offset relative under- and overperformance in some assets with that of others. ERISA, in fact, explicicly charges fiduciaries to "diversify . . . the investments of the plan so as to minimize the risk of large losses . . ."*.[5]

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[3] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(B)
[4] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(A)
[5] Employee Retirement Income Security Act of 1974 (ERISA), Section 404(a)(1)(C)

Some of the investments included in a well-diversified portfolio could be judged in and of themselves to have a relatively high element of risk. These kinds of investments can prudently be included if analysis of the factors listed above indicate a good fit with the rest of the portfolio and a beneficial effect on the financial health of the total portfolio. If the pattern of expected returns has a low correlation with other assets in the fund, the inclusion of such assets can increase the expected return of the total portfolio without proportionally increasing the total portfolio risk.

After the asset allocation decision is made (or revised), the funds are committed (or shifted), either by means of "in-house" investing or through independent investment managers. *It should be emphasized that the asset allocation does not typically change significantly over the short term, and plan sponsors, governed by the long term nature of pension payout obligations, generally invest with a long term view.* Although liability profiles differ among corporations, sponsors are generally less concerned with short term movements in valuations of asset classes than with longer term expected returns of the entire diversified portfolio.

Recently, attention has been brought to bear on increased short term asset turnover among "active" investment managers (i.e., those who attempt to exceed the return level of the overall market), some of whom manage pension fund dollars and, it has been postulated, trade more frequently because of pressure for short term performance from plan sponsors. It is our belief that most sponsors generally evaluate the performance of their investment managers on a three- to five-year time horizon or longer, which suggests that longer term evaluations are the more general rule. If trading volume among these managers has in fact increased, there are also other factors and recent trends in pension management that would balance out such an increase across the total fund. First, pension funds have substantially expanded their investments with "index" or "passive" investment managers, i.e., those who attempt to replicate the returns of the overall market. Trading activity in these accounts is of substantially lower volume than in active accounts. Second, pension funds have increased their investments in the private markets, such as real estate investments, venture capital, etc. Such investments are long term in nature and normally are not traded actively nor through the public markets at all.

It should also be noted that many of our members do not subscribe to the view that active trading per se is necessarily undesirable for the markets. Active trading contributes to overall market efficiency and investment liquidity, which adds to the attractiveness of an investment for most investors.

CORPORATE GOVERNANCE ISSUES (PROXY VOTING)

Although pension funds purchase equity securities for investment rather than control purposes, we are ipso facto owners of corporations as well. With ownership comes the responsibility to exercise ownership rights, including the voting of proxies. *In accordance with ERISA, these voting decisions, like investment decisions, must be made solely for the purpose of furthering the interests of plan beneficiaries. In a change of corporate control situation, this requires approaching the decision with no bias toward either the existing management or the prospective acquirer, and maintaining continual study and analysis of the actions of all parties to assess where the greatest value lies.*

As required by the recent DOL opinion letter regarding proxy decisions, such decisions are made either solely by the sponsor, or solely by the investment manager who is managing the investment. If the sponsor does not reserve the right to make the voting decisions, it cannot interfere with the decisions of the investment manager, who will have been charged to vote according to the best interests of the plan beneficiaries.

PENSION FUND INVESTMENT IN LEVERAGED BUYOUTS (LBOs)

The 1980s have been a time of heightened corporate restructuring activity of many kinds, including divestitures, asset sales, mergers, acquisitions, and LBOs. Much of this activity, we believe, can be attributed to changes in the optimal mix of corporate assets and business ventures demanded by a rapidly-changing business and economic environment

that is growing increasingly globalized and increasingly competitive. Another impetus, we believe, is an unwinding of some of the conglomeratization activity seen in the 1970s.

At the same time, we have seen a significant expansion in the aggregate level of corporate debt - a phenomenon that we believe should only be evaluated after a thorough examination of a wide range of factors, including the relative indebtedness and competitive position of U.S. firms vis-a-vis their foreign counterparts. While the complete picture of what has driven this second trend has not yet become clear, it is certainly true that any kind of restructuring activity can be financed with a large proportion of debt, and indeed there are significant tax incentives attached to doing so. Other corporate actions, such as stock repurchases and borrowing for capital expenditures, can also heavily weight a capital structure in favor of debt and increase financial risk.

Accordingly, it is our belief that it is important for the Congress to analyze LBO activity in its broader economic context, not as the sole driver of these more fundamental trends. Even though an LBO is largely financed with debt, and so most likely makes a greater than proportional contribution to the aggregate level of corporate debt, we feel that an attempt to address these broader trends by targeting LBO activity would be ineffective and might possibly have unintended consequences for other sectors of the markets.

According to our recent CIEBA member survey, approximately 1% of our assets are invested in LBO equity and/or debt, and about 30% of our members commit funds to these investments. Investments are made either through limited partnerships or, for a few very large funds, by means of direct investments in individual companies. Partnerships are managed by a "general partner," who typically invests only a relatively small proportion of the total capital, but shares more than proportionally in the profits from the investments. General partners also charge fees for managing the fund. Partnerships offer the protection of added diversification, since the funds own or invest in more than one company (typically a dozen or less); the "limited partners" (pension funds and others) are thereby largely shielded against a failure in any one company.

Sponsor fiduciaries who do invest in LBOs do so because they provide a high level of expected return and they enhance the return of the overall fund. Among CIEBA members, average annualized returns for mature partnership investments typically have ranged between 25% and 60%, with no investment losses to date. (Mature investments are the relevant measure; LBOs typically are structured with a four- or five-year time horizon with only minimal returns, or none at all, expected in the early years.) Returns on direct investments are in general higher, because either there is no general partner, and therefore no management fees and no sharing of profits, or the general partner receives a lesser proportion of the profits than in a limited partnership arrangement. Since each of these investments is in an individual company, it does not by itself provide the protection of diversification that partnerships do. These investments therefore require more extensive analysis that is generally only feasible for large, reasonably well-staffed plan sponsors, who most often invest in more than one company to achieve a better measure of diversification.

While the returns associated with LBO investments are typically very high, they do carry higher levels of risk than most other forms of pension investments. *Risk, however, cannot be isolated as the sole criterion for evaluating an investment. The investment must first be evaluated individually, balancing the risks against the expected returns, and then as a component of a larger portfolio of assets.* Individually, the level of risk present in any investment is directly related to its expected returns: assets in demand in the marketplace, by pension funds as well as other investors, are in demand only while their expected returns exceed or are commensurate with their perceived riskiness. In a portfolio, each asset's effect on the risk/return profile of the entire portfolio is the relevant measure for tests of prudence, not just the riskiness of each individual asset. As outlined earlier, including a relatively small proportion of high risk/return investments in a portfolio can enhance the overall return of the portfolio without proportionally increasing the overall level of risk.

Pension fund investments in publicly traded high-yield bonds must be examined in a similar way. High-yield bonds are less than investment grade

debt (generally, below a BBB rating), with relatively high risk and expected returns. While they are used to finance some LBOs, they also provide access to the debt markets for emerging credits, or companies which are not yet healthy or large enough to merit an investment grade rating, and for companies whose debt ratings have been downgraded.

As noted, we found in our survey of CIEBA members and advisory members that about 1.0% of our pension fund assets are invested in LBOs, including both direct investments and limited partnership investments. LBO investments and publicly traded high-yield bonds together constitute only about 2.3% of our assets. *With such a small proportion of assets involved, even total losses in all such investments would not jeopardize the security of the pension promise.* In fact, as noted earlier, the overall financial status of private funds is quite healthy, even as such investments have become more commonplace.

In order to further reduce the potential risks to the assets invested, we are also diligent in our analysis of LBO investments, as we are for all investments, recognizing that risk is a key element in these transactions. For partnership investments, we examine the history and experience of fund managers, in terms of background, record of price discipline, whether or not they invest in hostile takeovers, and other factors. For direct investments, we perform extensive financial analyses based on worst-case and recession scenarios. After investing, we exercise due diligence in monitoring, as again we do for all fund investments.

Even though the aggregate proportion of our funds invested in LBOs is quite small, and our perspective is that of the investor, not of the economist, we do not make investments that we believe may be detrimental to the economy over the long term, because we would be doing a disservice to our fiduciary responsibilities by damaging our future investment opportunities. While we would not assert that all LBOs and high-yield debt financing decisions are strategically sound, we believe that a conclusion that all such activity is inherently harmful to the economy would be equally inaccurate.

We do not propose to enter the debate about the economic implications of LBOs as a proponent or as a critic. There is, in fact, no consensus of opinion within CIEBA on either side; neither does there appear to be a consensus among government officials, in academia, or in many other sectors. The potential negatives have been amply covered in the press and in other Congressional testimony, and these views are shared by some of our members. They raise questions about the fate of these companies should the economy slide into a recession, the implications for employment and divestiture of assets, the negative effect on the value of the company's already outstanding debt securities, and the potential incentive for divergence of funds to debt service from investments in such activities as research and development.

CIEBA members who have a more favorable view of LBOs point out that LBOs can have many positive economic effects and can serve worthwhile economic purposes. Some (35% of LBOs in 1988) are undertaken simply because of a desire to sell on the part of the current owners, such as in corporate divestitures and sales of family-owned or otherwise closely held businesses.[6] Few, incidentally, are disproportionately large in dollar value; in 1988, fully 94% were under $1 billion in transaction size, with 88% under $500 million.[7] Most LBOs result in extremely high returns to the existing shareowners, including pension funds. With regard to the longer term implications for productivity and employment, these members feel that a capitalistic economy in the aggregate becomes more efficient in transfer of control situations, because employees and assets will tend to be reallocated toward their "highest and best use," even if short term dislocations occur. In the aggregate, the national unemployment figures will not support the supposition that most dislocated employees remain out of work.

There is also debate about whether or not the Treasury suffers a net revenue loss in an LBO. Some commentators have postulated that the Treasury in fact reaps a net benefit from an LBO: while interest deductibility reduces revenue from corporate income tax, the loss may be more than offset by tax revenues from sometimes more than 100% capital

[6]Source: Venture Economics, Inc., Wellesley Hills, MA
[7]Source: Venture Economics, Inc., Wellesley Hills, MA

gains by taxable shareowners, from tax on interest earned by taxable debtholders, and from tax on fees earned by agents.

The notion that does come through clearly, in our opinion, is that this issue is extremely complex and requires much deeper analysis than has been possible to date, and more time for the underlying economic forces to surface. We urge extreme caution in crafting a legislative solution. Overall, we feel that the market itself is the best regulatory mechanism for excesses, if they exist, and that it has, in fact, already begun to adjust. A legislative correction, besides being extremely difficult to design at this relatively early stage, carries with it the added risk of creating distortions in the markets and hampering their ability to self-adjust, especially if new laws should result in differential treatment among market participants. As the market forces evolve, close monitoring and study may reveal that legislation is in order, but until then, we feel that the risks outweigh the possible benefits.

For pension funds in particular, we would be seriously concerned about any prohibition or limitation on pension fund investment in LBOs or other investment options for several reasons.

First, there are more than enough economic and legal safeguards in place to assure that benefits are not being jeopardized, and the current participation level for the investments now receiving attention is far too low to cause concern for benefit security. We believe that ERISA is quite clear in its charges to fiduciaries, and that the flexibility it permits in allowing investment policies to evolve with the markets is an integral part of that mission.

Second, if the independent policy decision is made to curb LBO activity in general, then we do not believe that that goal could or should be accomplished by amending ERISA, which would affect private pension fund participation and could, as a by-product, disadvantage private funds in the markets relative to other investors. As long as investment returns remain attractive, any void left by the absence of private pension dollars would quickly be filled by other providers of capital not subject to government restrictions, such as foreign investors. We again believe that the market is best equipped to place a check on excesses, if they exist; when opportunities for advantageous realignment of assets abate, the pace of restructuring activity seen in the 1980s, of which LBOs are only a part, will undoubtedly slacken unaided.

Third, from a larger perspective, we believe that restrictions on corporate restructuring should be carefully examined for their unintended implications for the viability of the capital formation process. Eliminating financial buyers such as pension funds or buyout partnerships would limit many companies' options for sources of capital to other corporations or non-U.S. investors, and could possibly work to the detriment of corporations in their asset redistribution activities.

Finally, as we pointed out at the beginning of this testimony, we would urge caution in tampering with a retirement system that works, and that has withstood far more severe tests than this for many years. We are confident that it will survive this one.

Chairman PICKLE. Now, Mr. Weizmann.

STATEMENT OF HOWARD C. WEIZMANN, EXECUTIVE DIRECTOR, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. WEIZMANN. Thank you, Mr. Chairman. I am told that brevity is the soul of wit. I cannot attest to the latter, but I will at least attempt at the former.

Chairman PICKLE. Your entire statement will be entered into the record.

Mr. WEIZMANN. I am here representing the Private Pension and Welfare Plans as their executive director. We represent approximately 400 employers, consultants and insurers and people in the benefits area.

Over the last 40 years, we have seen that system grow to over $1.2 trillion. They hold, according to one study, 17 percent of all corporate stocks and 17.5 percent of all taxable bonds.

At the same time, these funds constituted 34.8 percent of nonbank, if you will, investments. In a country where the savings rate has hovered around 3 percent over the last 5 years or so, pension funds and contributions to pension funds represented over half of new savings in 1986.

At the same time, my association is concerned that the defined benefit system is a system in trouble. Congress, for numerous reasons, some good, some not good, have, in fact, enacted seven separate statutes over the last 7 years dealing with the employee benefits area and pension plans specifically.

The level of complexity in dealing with these plans has grown many-fold. Fifteen percent of the Tax Reform Act constituted revenue-raisers associated with pension funds. At the same time, fully a third of the physical presence of the act dealt with employee benefits and with pension funds.

The result is that the system that doesn't grow or didn't grow overnight doesn't die overnight. But we note that in 1988 only 27 percent of all plans that filed for qualification letters or determination letters from the Internal Revenue Service were new defined plans.

It is a system in trouble. Current law requires that trustees and plan fiduciaries invest their funds in a prudent manner. It requires them to diversify investments. They are also required to act in the best interest of their participants.

At the same time, while, as the gentleman to my right indicated, there may be potential for abuse of, or in the nature of conflict of interest, the system works very well, as can be attested by the growth in case-made law where rights of all those involved are adjudicated based on the standards set forth in law.

The principles in law are very clear, and everyone has an interest in seeing those principles upheld. If you don't, you get sued. If you do, you don't.

Pension funds as investment vehicles have indeed contributed some minor portion of their assets to LBO funds. However, I think because of the legal diversity of investment requirements, we can see that when the market crashed in 1987 after some years of LBO activity during that period of time or prior to that period of time,

pension funds sustained only about a 10-percent loss overall while the market fell 25 percent and ended up the year in 1987 with a gain of 6.6 percent.

Are these funds invested too heavily in LBO's? I think the proof is otherwise. Do pension funds figure in LBO's? Yes, they certainly do. Surplus assets certainly do represent funds that are, if you will, included in the pension or the LBO equation.

One cannot deny that. At the same time, surplus assets and pension funds do not cause LBO's, nor necessarily do surplus assets or LBO's themselves cause terminations of pension plans.

LBO's occur because of complex reasons, some having to do with the restructuring of the United States industry in general, some having to do with perhaps other issues that are extraneous to pension funds.

Basically, when a plan is terminated, employees' interests are protected, simply by the structure put in place in 1974 by ERISA which created the PBGC. I want to compliment the Chairman for working so hard in 1987 to push the Pension Protection Act which secured the funding for a lot of pension plans and made sure that the plans would not be underfunded in the future.

At the same time, employees' interests are protected by well-funded pension plans. Retirees' interests have been protected as well, simply by virtue of the fact that their benefits were guaranteed through an annuity purchase.

There is no loss of benefit resulting from a termination. Do LBO's change that equation? The answer is simply no. Have there been a lot of LBO's that figure in plan terminations? Perhaps.

But I must add that since the passage of ERISA, only 2 percent of all assets have been recovered in the form of a surplus asset since that period of time.

In closing, I think I would just note that we are concerned that, in trying to fix a problem with regard to reversions, by simply requiring that employers give the surplus away to either retirees and/or active employees, our concern is that we will benefit a few and at the same time detriment the great many employees who currently participate in the system.

Employers, as a response to legislation limiting their right to surplus assets, will begin to narrowly fund the pension plans. I come from a company that in 1973 and 1974 saw approximately one-quarter of its value eroded when the market—this is before the ERISA diversity requirements applied, and in fact before the funds were as diversified—but saw a quarter of the pension fund eroded by market activity.

We are very concerned that employers continue to fund their plans well and are concerned that employers will not fund their plans well if they are giving money away to people to whom the benefit promise has not been made or has been fulfilled.

I want to thank you for holding these hearings, and again, I welcome any questions that you may have.

[The statement of Mr. Weizmann follows:]

STATEMENT OF

THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE

COMMITTEE ON WAYS AND MEANS

OF THE U.S. HOUSE OF REPRESENTATIVES

ON

"UTILIZATION OF PENSION PLAN ASSETS

IN LEVERAGED BUY-OUTS AND RELATED TRANSACTIONS"

THURSDAY, APRIL 27, 1989

Washington, D.C.

Howard C. Weizmann
Executive Director

As the Executive Director of the Association of Private Pension and Welfare Plans (APPWP), I am pleased to be able to address this subcommittee regarding an issue which has so sparked the concern of the Ways and Means Committee and many others. The APPWP is an association of approximately 400 employers, actuaries, consultants and insurers who are united in there desire to sustain and foster the private benefits system. Together the APPWP's members sponsor plans, represent, or manage the assets of literally hundreds of billions of dollars and, as a result, we are concerned that the Ways and Means Committee's legitimate concern over the emotional issues surrounding leveraged buy out (LBO) activity might lead it to act in ways which ultimately could be destructive of the system itself.

Private pensions contain more than 1.2 trillion dollars in assets. They hold, according to one study, 17% of all corporate stock and 7.5% of all taxable bonds. At the same time, these funds constituted 34.8% of all non bank and thrift investment capital in 1986. In a country where the savings rate is hovering around 3%, contributions to pension funds represented over half of new savings created in 1986.

At the same time it is system in trouble. Many employers, both large and small are opting out of the defined benefit system altogether for a variety of reasons many of which have stemmed from legislation spawned by deficit reduction or perceived equity needs. Congress has significantly revised the rules by which the pension game is played seven times in the last seven years. Fully one third of the 1986 tax act was devoted to employees benefit provisions and 15% of the revenue raised came from these changes!

The benefits community has at times been accused of crying wolf when we talk of the system's death. However, the system was not built in a day--enlightened tax legislation dating from the 1920's planted the seed--and likewise it does not die in a day. What information we have tells us that the system is declining. In 1988, only 27% of all new plans which filed for determination letters with the IRS were defined benefit plans. Contributions to pension plans have declined. But statistics tell only part of the tale. Many of our members tell us that they have not created or recommended the creation of a new defined benefit plan for many years.

Against this backdrop we are asked once again to think about overhauling the system to curb perceived abuse or even more accurately the "potential" for abuse. The APPWP believes that the inherent checks and balances in the area of mergers and acquisitions provide disincentives for abuse and also provide appropriate remedies where such abuse occurs. To increase the regulation of those involved in these transactions will needlessly restrict the

investment of new capital, so vital to the restructuring of American industry, and ultimately add another reason not to have a pension plan.

CURRENT LAW ADEQUATELY SAFEGUARDS THE INTERESTS OF ALL INVOLVED IN A MERGER AND ACQUISITION

The Employee Retirement Income Security Act of 1974 ("ERISA") established the standard by which planfiduciaries must be measured. Under this standard a fiduciary "shall discharge his duties...with care, skill, prudence, and diligence under circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." Plan fiduciaries are charged with the responsibility of acting in the best interests of plan participants. Moreover, ERISA requires plans to diversify investments and forbids self-dealing through specific "prohibited transaction" requirements.

The U.S. Department of Labor also monitors the activities of plans. Through the issuance of regulations governing plan assets and the fiduciary standards regarding the disposition of these assets, plan fiduciaries, either corporate or independent, are guided in the types of acceptable practices or considerations regarding the investment of plan assets. At the same time, through the issuance of guidance through its advisory opinion process, the Department of Labor has established a body of common law as to the duties and responsibilities of those involved in corporate acquisitions or mergers.

FIDUCIARY RESPONSIBILITIES DURING TAKEOVERS

As noted, ERISA requires plan fiduciaries to act in the best interest of plan participants. There is no distinction in the law between corporate or independent trustees or financial managers or other fiduciaries. This means that all issues regarding the disposition of plan assets and voting rights must be resolved in favor of plan participants. It does not necessarily mean, as the Department of Labor has advised, simply accepting the highest offer during a tender for stock.

While this is a simple standard to enunciate, plan fiduciaries seriously take their role to act the best interests of participants particularly in takeover situations. This is not simply out of respect for what is right and fair. In both friendly and hostile takeovers, the various parties have an interest in following both the spirit and the letter of the law. False steps regarding conflict of interest and other issues in the disposition of pension assets and/or voting rights frequently are the subject of litigation or government censure. As a result, the case law involving the target employers, the acquiring parties, employee groups or their representatives, government administrators, and defining the duties and responsibilities of plan fiduciaries is growing.

Where independent trustees are engaged it is often with the express understanding that their responsibilities are to act in accordance with law, (i.e. in the best interest of plan participants.) In cases involving typically smaller plans, where the plan fiduciary may be a corporate individual, inherent conflicts of interest that may exist must by law still be resolved in favor of plan participants. To do otherwise would subject the individual to fiduciary violation.

In sum, the law regarding the actions of plan fiduciaries during takeovers, LBO's or otherwise, is clear. That these standards may from time to time be violated and are subject to legal action doesn't mean that the law governing the sanctions of fiduciaries is weak or needs to be changed. That relatively few such challenges have been brought by either the government or parties with adverse interest is testimony to the fact that the law is operating as it was intended.

As a result of the legal safeguards already existing in this area the pension commitment to employees whose funds may have invested in LBO pools is secure. Because of the diversity requirement, only a relatively small amount of plan assets are invested in LBO equity and/or debt. For example, in a survey conducted by the "Committee on Investment of Employee Benefit Assets" of the Financial Executives Institute, of member employers whose total asset investment was close to a half a trillion dollars it was found that no more than one percent of all assets were invested in LBO related securities.

Similarly, a more limited GAO survey recently submitted to the House Subcommittee on Labor-Management Relations recently found that the plans that were studied had invested only a relatively small portion of their assets in LBO funds and had received a higher return than achieved on other plan investments. Moreover, the GAO noted what plan sponsors already know, that the funds are selective in choosing which funds to invest in and are very conscious of the need to diversify investments.

In the end the proof is in the pudding. When the Market Crash of October 19, 1987 occurred, pension funds lost, on average, 10.4% of assets despite the fact that the market itself lost approximately 25% of its value. And pension plans finished the year 1987 with a net investment gain of 6.6 %. These positive results for pension plans existed despite the fact that they came after several years of LBO transactions.

THE USE OF PENSION FUNDS DURING HOSTILE TAKEOVERS

Pension assets have given rise to a series of defensive measures, some of which are designed to protect current management and some of which seek to enhance the benefit security of participants in various corporate benefits programs. Two types of defensive measures seem to have been popular in recent years. The first is the poison pill approach which seeks to ensure that any surplus funds (i.e. amounts over and above that which is necessary to provide currently accrued benefits) available in pension plans must be used to increase plan participant benefits if the plan is terminated following a hostile takeover.

The second approach has been termed the "slam dunk" ESOP. This typically occurs during the course of a takeover as a defensive measure on the part of corporate management to put corporate stock into the hands of an independent trustee and corporate trustees. This may involve the termination of other corporate plans or may be arranged directly by corporate management's sale of stock to an ESOP. The theory behind it is an attempt to get the stock of the company in the friendly hands of those who have the most to lose--the employees.

Are these defensive measures in need of legislative restriction? Here the answer of the APPWP would be a firm "no". The disposition of surplus pension assets remains the prerogative of plan sponsors for strong public policy reasons, described below. Benefits accrued to date are protected under current law and, as such, the same level of retirement income security exists both before and after the defensive transaction. The fact that an employer uses the surplus funds to benefit its employees through additional stock or additional benefits does not interfere with the retirement security attached to the benefit earned up to the date of the transaction.

While the use of the ESOP in the context of a hostile takeover has been criticized it does bring employees directly into the decision making process; making it far more equitable. Insofar as the trustee who represents participant interests or the employees vote to retain current management, the tactic works. Insofar as the deal being made is too attractive to pass up, the trustee and/or employees may very well tender their stock and the tactic fails.

A more important, but little recognized aspect of pension takeovers involves the disposition of nonqualified or unfunded plans. These plans may promise the restoration of funds lost as a result of limitations under defined benefit or defined contribution plans. These commitments have grown substantially as Congress continues to reduce the dollar level of those who are considered highly paid, either overtly or implicitly, by freezing benefit limits. More importantly, medical benefits for current or retired employees are also at risk during takeovers. To cope with the issue of security many companies have experimented with "Rabbi Trusts" which receive no tax advantage from the federal government, but ensure that benefit promises are secure (except as to corporate creditors) following a takeover. We would encourage lawmakers to explore with us ways to guaranty such benefits.

SURPLUS ASSETS IN PENSION PLANS DO NOT CAUSE LBO'S

LBO activity particularly when followed by the termination of a defined benefit plan has given rise to the presumption somehow that pension surplus entices unfriendly suitors. Following the acquisition of a company, pension plans are sometimes terminated and surplus assets recovered. Critics use this fact as a reason either to curb LBO's or to curb an employer's right to the surplus assets in the pension fund. While the APPWP is second to none in its concern that employers are leaving the defined benefit system, we are likewise concerned by those who are using the issue of LBO's as a trojan horse to gain access to surplus pension assets which, for strong public policy reasons, does not belong to them. Were this to happen, the private defined benefit system would be seriously undermined.

From the passage of ERISA until 1987, Congress encouraged employers to fund plans on a projected benefit basis. This means that employers could contribute amounts to pension plans which would provide retirement benefits for future retirees. To encourage employers to generously fund these plans, Congress placed no restrictions on an employer's right to gain access to surplus assets which would remain in the plan after all employees were vested in their promised benefits as a result of the termination. In 1987, Congress limited contributions to 150% of current liability and employers essentially lost the right to fund plans based on what they know future costs will be.

While we have no expertise regarding the use of LBO's and the subsequent restructuring of companies, it does not take an expert to know that traditional American industry is undergoing a huge transformation which will either insure our competitive position or will doom us. To make this restructuring successful will require huge amounts of domestic capital which will be hard to raise. In those industries where an LBO is attempted or succeeds, the argument is invariably that corporate assets are improperly deployed and that better use can be made of them elsewhere. Significantly overfunded pension plans may fall into this category. The recovery of these assets, therefore, may serve to save an industry and jobs with it.

Should the pension policy permitting the recovery of surplus assets be altered to limit an employer's right to surplus assets in LBO situations? Here once again the APPWP would respond emphatically--no! Terminations, whether as result of an LBO or not, result in no loss of benefits to retirees for whom the promised benefits have been guaranteed nor do they result in the loss of promised accrued benefits to active employees. Surplus assets in a pension fund ensure that sufficient assets exist in the plan to survive market cataclysms such as befell pension funds in 1973 when many lost over a quarter of their value. To get employers to decide to maintain an asset cushion it is imperative that their rights to what is essentially a corporate, not a plan, asset remain inviolate.

From the passage of ERISA in 1974 until the end of 1986, surplus asset reversions constituted little more than 2% of total defined benefit plan assets. Most employers with surplus assets have no desire to terminate their plans. However, by restricting their rights to amounts in excess of benefit promises, even if limited to LBO situations, sends a message to those plans to reduce contributions and the cushion of employee security with it. In the end we reduce the security for all to enhance the benefits of a few.

CURRENT EFFORTS TO RESTRICT REVERSIONS

The foregoing discussion and testimony presented both to this subcommittee on previous occasions and to the Education & Labor Subcommittee on Labor-Management Relations, amply describes the APPWP's concerns that restrictions on pension reversions will harm the cause of sound pension plan funding. Current legislation pending before the Congress, the "Employee Pension Protection Act," H.R.1661 and S.685, would discourage sound funding and also radically re-define the nature of the pension promise to employees and retirees by granting mandatory legislatively-determined pension benefits to employees and retirees of firms whose pension plans terminate with surplus assets. These Congressionally-determined benefits would, if enacted, represent the first time that Congress has ever become involved in determining the level of pension benefits that are paid and it would constitute a "gift" of employer's money to employees and retirees who had not bargained with their employers for such benefits.

The bill also raises but fails to resolve several critical Federal tax issues. Questions relating to: the maximum funding limitation of defined benefit plans, spousal annuity requirements, and the current law 15% excise tax on reversions are all important tax issues that are either not addressed by H.R.1661 or are in conflict with the bill as written. It is critical that these important policy issues and practical Federal tax questions are addressed if employers are, once again, going to be required to comply with changes in the law relating to pension plans.

Finally, we would urge that the Ways & Means Committee use the opportunity to review the proposed pension reversion legislation in order to consider proposals to use pension surpluses for providing retiree health benefits. The Committee presently has before it H.R. 1865, introduced by Rep. Rod Chandler and Rep. Ronnie Flippo. We urge the Committee to review this measure and also to consider the APPWP's long-advocated proposal for allowing pension surpluses to be used as a partial solution to the critical issue of funding retiree health benefits.

CONCLUSION

In sum, the APPWP would urge that the Ways and Means Committee take no specific action regarding the use of pensions in LBO transactions. Current law adequately safeguards both pensions and participants from abuse, and defensive measures involving pensions tend to give employees either larger benefits and/or a greater say in the takeover process. Finally, it is our position that the surplus assets remaining in a pension fund after its termination are an asset of the employer and we would hope that the Committee would not seek to alter the delicate balance of incentives which have encouraged employers to contribute prudently and generously to their plans.

Chairman PICKLE. Thank you, Mr. Weizmann.

Let me say that I appreciate your comments about the legislative changes we made in the last session to the pension program in our effort to try to shore up the underfunded plans and see that more of the plans are financially sound and properly funded.

I think it was an important law that we passed and probably is underestimated in value by a lot of people. But it was a good, strong step in the right direction. And we have to keep a careful watch now that it will be enforced.

I say to you, Mr. Weizmann, that we have had some witnesses here today who have testified that the plan termination reduces the size of the pension benefits and that some of the plan participants will expect to take a reduction on these plans.

I assume that you agree with that analysis? Would you or your organization support an effort to protect the interest of these participants, not have the reversions?

Mr. WEIZMANN. Mr. Chairman, we would support anything that we felt further defined benefit system. However, we are concerned that in so protecting it, we will throw the baby out with the bath.

The concern is that employers right now are not creating new defined benefit plans. If we modify and continue to increase the complexity applied to these plans, or in fact if we modify whose surplus this belongs to, whether it belongs to the employer which bears the investment risk of poorly-invested funds we are concerned that any action taken on those lines is only going to pour gasoline on an already raging fire.

Chairman PICKLE. You say you are concerned that if any action is taken——

Mr. WEIZMANN. Yes, which really does protect the interests of both active employees by guaranteeing their currently accrued benefits, and when it comes to the area of retirees who have already been promised those benefits——

Chairman PICKLE. Well, Mr. Schanes, you have stated that on these, when these terminations take place, they do hurt the participant?

Mr. SCHANES. Yes, sir.

Chairman PICKLE. My question to you then is, doesn't any plan termination really cause damage to the participant. Is that correct?

Mr. SCHANES. It depends on what the employer then does with respect to the continuation. In some instances they are not providing replacement plans, and in some instances they are providing defined contribution plans.

Chairman PICKLE. In most instances, it does hurt the worker, though they might go ahead with a new plan that is just as good?

Mr. SCHANES. Yes, sir.

Mr. WEIZMANN. Mr. Chairman, the notion is it is based upon an expectancy. I expect to win the Pennsylvania lottery today, however, I am not going to buy dinner based on that expectancy.

By the same token, employers make promises and fulfill those promises during the course of the length of the plan. There are business circumstances, obviously, and exigencies that employers cannot foresee reasonably, but the benefits are accrued up to the date of the termination are guaranteed and are paid and I think that is an uncontestable fact.

Chairman PICKLE. I will ask a general kind of hypothetical question, I guess, to Mr. Schanes more than anyone, because of the organization he represents. When you have an ongoing pension plan and there is a termination, there is no statutory obligation that it provide increased benefits to that employee. If there is no statutory obligation to provide these increased benefits, is there any justification for requiring benefit increases for retirees when an overfunded plan is terminated?

Mr. SCHANES. You are talking about a cost-of-living adjustment or something like that beyond what is given?

Chairman PICKLE. Yes.

Mr. SCHANES. There is nothing by statute that would require that, no sir. Are you just saying philosophically?

Chairman PICKLE. Yes, philosophically.

Mr. SCHANES. Philosophically the fact is that a number of plans, affecting about 40 percent of the retirees, have provided a cost-of-living increase. Our interest is in something, thereby some level of recognition of the eroded dollar on behalf of the employee?

Chairman PICKLE. Mr. Schanes, in the past it has been asserted that retirees are adversely affected by the termination of a defined benefit plan and I think normally we would have to say that is correct, because they lose the benefit guarantee offered by the PBGC when their benefits are annuitized and future payments are made by an insurance company. Are you or your organization aware of any instances in which an annuitant has failed to receive a benefit as a result of insolvency on the part of an insurance company?

Mr. SCHANES. Mr. Chairman, there are two different aspects to that. First of all, there is the level of what PBGC guarantees. To some degree they do not guarantee 100 percent of the benefit, depending on the priorities, and the formulas of PBGC. So not all retirees are guaranteed the benefit which they are receiving in total.

Setting that aside for the moment, where annuities are purchased, there is no loss, Mr. Chairman. That is not the question that I think you are raising. The question which you raised with me has to do with whether or not there is some justification for a further increase later on, and that is a philosophical point, and has to do with whether one feels it should or should not be, that is all.

Chairman PICKLE. I know. You have to say if it is not required in one instance, why should it be required in the other. Though it may be a philosophical question, it is something we all have to ask ourselves.

Mr. SCHANES. Yes sir.

Chairman PICKLE. Ms. Teslik, your organization has been very active in protesting against the antitakeover measures that have been espoused by various groups. What are some of the antitakeover devices that you or your organization would judge to be abusive?

Ms. TESLIK. Well, I don't know that the council should be characterized as protesting the shark repellant and the anti-takeover legislation blanketly. We certainly have great concerns about them.

One of our biggest concerns is most of the shark repellants can be enacted without any shareholder ability to vote on them when they are enacted or to affect them after they are enacted. The system of corporate governance as it exists right now, even before

many of the shark repellants were enacted, is such that even very large shareholders have virtually no say in the corporation.

Not that we would like to have a say in day to day management decisions or board decisions. We don't. That would be inappropriate and would be foolish on our part. But we would like to have that ultimate ability to have some impact on major questions that a corporation faces.

There are certainly shark repellants that are more outrageous than others. One of my favorites is Phillips Petroleum's provision that if a raider buys the company and then fires anyone right down to the janitor, he has to buy their house. I keep thinking if you modify that a bit and say you have to adopt their children, it would take care of takeovers altogether.

There are certainly ones where just the terms of them give you pause more than others, but I think you have never even, I don't believe any council member, much less the council, would come out and say, for example, that all poison pills are bad. Almost all of the proposals that members have filed have asked that there be a shareholder vote on them, at some point that they be open for renewal, that they become chewable, in other words.

So we have to be very careful and make clear what the council's concerns are.

Chairman PICKLE. I don't know that I can fully appreciate your answer. Are you saying that in these takeovers a company ought to not to try to resort to any effort they can to keep from being taken over? Should they let the market take place and let the big eat the little?

Ms. TESLIK. No. Companies are certainly entitled to appropriate defenses that allow for organized markets, that allow for the passage of information.

Chairman PICKLE. If they are entitled to that, what are some of the things they are doing you think are bad and wrong?

Ms. TESLIK. As I said, I think our biggest concern is that some of the measures they have enacted essentially usurp all power of shareholders to have any say on even an ultimate question like the sale of the company. It is not that the repellant is there or they are trying to slow things down. It is that it effectively removes the shareholder. You are completely at the mercy of the management's decisions on the big questions.

We should——

Chairman PICKLE. Are they operating in the shareholder's best interests as they contend?

Ms. TESLIK. I would certainly say that probably on average most corporate managements and boards do. Even if they didn't, we would not be in a position to second guess them. We shouldn't try to do their jobs, but I think the idea of the corporation is that while the shareholders are the owners and not the managers, there has to be some ability at some point, if something goes badly awry, the shareholders can step in and say no, or they can say we would like to have a say in the sale.

It is only that kind of role that I think is appropriate for shareholders, and the only role we would seek.

Chairman PICKLE. Well, it is a problem. How can you let shareholders properly express themselves? At that stage of the game it

is hard for them to do so, although we do try to have a vote. It is cumbersome sometimes to get that done.

You made a statement earlier that you said some of your investors were complaining to you that we weren't really making long-term investments and that you objected to that. What steps have you taken, as a council now, that would say to a pension fund that they ought to properly invest their funds better than they are? What specific advice have you given as your official position?

Ms. TESLIK. In advising pension funds?

Chairman PICKLE. Long-term investments, that the funds are invested properly.

Ms. TESLIK. The whole world of the council is to serve precisely that educational purpose. The leading funds can provide the information to the smaller funds that may not have the staffs. We provide information, for example, the surveys that demonstrate that you are not money ahead to be an active churner.

You provide information on the kinds of vehicles that are available, whether it is one kind of index or another, the kinds of things that a prudent fiduciary should be concerned about. That is the role of the council, to be an informational source.

We also, for example, collect the data from our members on what their holding patterns and turnover figures are. I think there is some concern on the part of some pension funds that if they are too passively invested they are not doing their jobs, so they need to know what others are doing to understand that putting money in an index doesn't mean you have a heartless disregard for corporate America. It means that you are not trying to churn it away to make some money.

I think even funds have different circumstances and different funding obligations. It is hard to have set rules, but we do try to provide that educational function.

Chairman PICKLE. This may be an unfair question to you. I asked myself, you represent the Council of Institutional Investors. Would it be unfair to say that your industry is investments and when there is a takeover, hostile or friendly, that means there is going to be turnover of assets and more investments, and regardless of whether it is good or bad, you want investments. That is all you are interested in?

Ms. TESLIK. I think we would be foolish to pretend that we are management or board and try to take on their jobs. I know it is a problem that many corporate executives, when sitting down with us, have said you don't care about my company the way you care about our company.

I say you are right, we shouldn't. We do care about how it performs because our portfolio doesn't do well if every building in it doesn't do well, but I shouldn't try to do your job because I don't know as much as you do. I do care in a long-term way, because our concern is pension funds putting more money into the market daily, not taking money out.

Yes, I care in a different way. If I step in to to try to second guess you that is going to harm me and it is going to harm you, but that doesn't mean I don't care a lot about how you perform.

Chairman PICKLE. I don't think it would be critical of your organization to say that, yes, you are interested in making investments

in the market and when there is a takeover that is going to take place, you relish the idea because that is activity for you. You are not going to be happy to sit here and make no investments, so it is very natural if you see that it is going to take place, you want to have part of the action. You want to see investments made.

I don't know whether that is good or bad, but I think that is a fact and that is the way to look at it. You are more interested in being sure the volume of investment continues rather than the status quo. Is that an unfair observation?

Ms. TESLIK. I am not sure I understand it. We certainly are not in a position, with all the various takeover activity that takes place, to do a lot of second guessing and our interests are, in fact, long term. That is what a pension fund is. So we would have a concern that the takeover activity, that if in fact it is detrimental to the economy over the long term, that we have an interest in not having it continue.

I am not sure that we have made that conclusion, but we are ultimately the ones who are hurt more than anyone else if any kind of market activity is not healthy for the economy. So I think it would be probably an unfair characterization to say because we are investors, we don't care about the effect of those things or the bigger picture.

Chairman PICKLE. I don't think that is an accusation. I was making an observation.

Ms. TESLIK. It is something funds don't realize fully yet, and there are a lot of pension funds out there that don't realize that and think they can execute their money in here and execute it out there, and that is all that matters. But there is no place for us to hide. If you are 40 percent of the market, however the market is doing affects us in a big way, and we have to care about the bigger picture issues.

I think the term, what it means to be a prudent investor, is changing. It used to be you knew well asset allocation use, you knew how to pick stocks, you knew how to pick bonds. I think a fiduciary who sticks to only those activities right now isn't doing his or her job.

Chairman PICKLE. Mr. Feldman, you represent a large company and you have heard witnesses earlier say when you do have these plan terminations, it is the participants that are really hurt, whether it is in an overfunded plan or whether it is just a normal plan or it is brought about by a leveraged buyout. I think it is pretty much recognized in most instances an employee will not get as good a pension value down the years as he has had all along if he is getting full past service credit. Some new plans might give it. It might be, but by and large it is true that benefits are lost.

Now, if that is so, wouldn't it be better for you people in the large companies to resist those possible hostile takeovers? There is a lot of money changing hands, but the net effect of a lot of these takeovers is to hurt the plan participant. Would it be better for you to oppose all hostile takeovers?

Mr. FELDMAN. Mr. Chairman, as an investor in leveraged buyout activity—I am stepping out of my CEIBA role here and I will talk about what I do in AT&T, because I am not aware of what the other 39 folks do, but we have restricted all of our leveraged

buyout-type investing, which is a very small percentage of the total assets, to managers who engage only in nonhostile takeovers. Before committing any money, we have very long and detailed discussions with them about their investment philosophy, how they go about it, how they intend to add value, and we also look back at their track record and what they have done in the past.

We have passed by a number of investors who say they don't do hostile takeovers but some might say they have come very close to doing that. So we do not think as investors that it makes good sense to support hostile activity.

Chairman PICKLE. Well, it is a complicated question, these takeovers, and many business organizations contend that it is so complicated we ought not to have any additional restrictions put on the program, just let the market take place.

If we are going to have any resolution though on the leveraged buyout question, we have got to make some compromises between the business world, and the marketplace. If it is determined that leveraged buyouts do lead to an unacceptably high level of benefit plan terminations, should this be limited through additional restrictions on leveraged buyout transactions, or should additional restrictions be placed on the use of the assets in pension plans?

Any of you can make a comment on that.

Mr. Schanes.

Mr. SCHANES. Our position clearly is there should be restrictions on the use of those assets, Mr. Chairman.

I would like to say one thing about a phrase which everyone seems to accept and which I would like to at least have the Chairman think about challenging or have challenged, and that is the commonly accepted phrase "the employer takes the risk, therefore, he should take the gain." That has been a commonly accepted phrase for many, many years in the industry.

I have come to the conclusion after much contemplation, that is not the case.

Chairman PICKLE. Any of you disagree or want to comment on that?

Mr. Feldman.

Mr. FELDMAN. Yes; I think you clearly have to look at the individual circumstances of a company and somebody that is in bankruptcy is in a more difficult situation than an ongoing, viable corporation, which is by far the vast majority of those people covered by pension plans.

It is clear that under defined benefit plans we have made the promise of a certain level of benefits to our pensioners. We expect to carry that out and if the investment performance falls short, as it does from time to time, the business has to pick up the slack. So I think in that sense of a viable, ongoing organization, the investment risk is clearly on the side of the corporation.

Chairman PICKLE. Overall, I think I would observe, or at least I hope, that the takeover situation will subside and that there won't be such emphasis put on it. It is my feeling that takeovers are more the new game in town for tax purposes, rather than for productivity. Then you get involved in pensions and pension funds, and, I think it is fair to say pension funds are used in these leveraged buyout situations.

All this activity is growing, and it may be more than we think, and we are trying to get some figures on that. As we go along this is going to continue—the discussion—because under present law, you can have termination and asset reversions. We know it hurts plan participants when it happens, and the question is, How do we protect them? The biggest push right now is what are we going to do regarding the pension plans that have built up excess assets, and do we allow them to continue to terminate, and can we say they can divert that money into retiree health plans?

What is the position of each one of you on using these retiree's funds, or some kind of prefunding system, for retiree health? Would you be for that prefunding activity or not?

Mr. WEIZMANN. Mr. Chairman, I would like to strongly endorse that suggestion. We feel very strongly that the assets in the pension plan or pension funds should, at least within range of options available to employers upon a termination, be able to be used to guarantee benefits which right now, quite frankly, are not funded or cannot be funded under current law.

Chairman PICKLE. Mr. Feldman.

Mr. FELDMAN. Yes, Mr. Chairman.

I would second that, speaking for AT&T, and not necessarily for CEIBA, although there is a strong body of support within the organization for something like that. I think everyone's intent is that these assets go to benefit retirees and the changes in the accounting practices plus the strong inflationary trends that have taken place in health care costs, leave all of us on the corporate side with a very large liability to deal with.

We have been blessed with 6 or 7 years of very strong markets and I think at least a little bit of astute investment management. To the extent there are legitimate surpluses in the pension plans, I think that would be an idea place for them to be directed.

Chairman PICKLE. Ms. Teslik.

Ms. TESLIK. That is not an issue with which the council deals, or has any policies.

Chairman PICKLE. I understand that.

Mr. Schanes.

Mr. SCHANES. Yes. Our position would be the pension fund should honor its obligations first to the participants in the pension plan, before excess assets above those on a current basis could be used for other purposes, such as retiree health. But our first emphasis must be on the participants in the pension plan.

Mr. Weizmann answered your question with respect to terminating plans, Mr. Chairman. In that specifically AARP has a position there be an allocation of assets before there be any other diversion met. After that allocation, if it is used for retiree health benefits, that is fine to discuss.

Chairman PICKLE. If this plan is adopted, I raise the question, Is that fair to all other companies who do not have pension plans or who don't have excess funds for such reversions? There is an amount of money on hand in some of these programs where assets are built up. You could transfer those funds over into prepaid retiree health plans. Is that fair to all other companies?

Mr. SCHANES. One would have to start at the beginning, Mr. Chairman, and determine why some companies were determined to

have some type of benefit structure and others have another type of benefit structure, and whether some could afford it and some could not. That is business conditions.

I would hesitate to get back into the basic economics of this country. The fact is, however, that when the money has been set aside in pension plans by the employer, and then the pattern of investments and continual contributions as required by statute follows, the money should be used for a pension purpose. Incidentally, I would not say if they no longer has access to the excess assets, which employers are required to fund in accordance with the statutes you have enacted, and in accordance with those obligations of the employer from the moment he has established the plan, that he was caught by ERISA. The others who have not sought access to plan money have not, and that is the fact of the matter.

Mr. WEIZMANN. We fully agree with AARP as far as the matter pension obligations need to be satisfied before the benefits are transferred certainly to fund other benefits.

Where we differ, however, is in the fact that AARP and some other groups in town I think would like to see the size or the amount of assets or surplus assets severely reduced by, in fact, heightening those obligations, obligations that employers did not sign on to when they adopted the plan and maintained the plan during those years.

Chairman PICKLE. Well, I think we are getting ahead of our purpose of this particular hearing, but we have a lot of questions about how we approach this issue. I don't know that it is fair to all other companies if you divert these funds. I don't know whether it is legal to raise money for pension purposes, retirement purposes, and just divert that money over into health purposes automatically.

Mr. WEIZMANN. Mr. Chairman, if I might say, the issue with regard to retiree income really is an issue that cuts across not only just simply the fact of having dollars on hand to pay for life styles and living, but in fact, also certainly carries over into these years of retiree health.

Chairman PICKLE. The first question I think we will have to ask ourselves—I am not going to pursue this, but should the Federal Government—should we get involved in the retiree health plan and should we pre-fund them? Should we get into that business? That is the big question. There is a great temptation for this money in those excess funds to transfer it over. That would suite some companies but it sure would be disadevantageous to others. That is another issue we will be facing down the road.

Mr. Schanes, before we leave, my staff asked me to ask you the specific question about the values of the pension plan that is affected by workers when they lose out. They say active workers may not get a benefit they would expect to earn but retirees have already gotten that benefit. Is that not basically correct?

Mr. SCHANES. That essentially is the case. The retiree has received that which was promised. The active employee received a promise when the pension plan was established or when he joined that plan. Assuming the employer can continue in business he will receive a certain benefit based upon that promise. But now the employer is terminating somewhere beforehand and the anticipated benefit further on is not being provided, yes.

Chairman PICKLE. That would make a difference, wouldn't it?

Mr. SCHANES. Yes sir.

Chairman PICKLE. I want to thank this panel. We appreciate your testimony and all of it will be considered by us and we will be holding further hearings on this issue, because I think we are just beginning on this overall subject.

If there are no other questions, the committee will stand adjourned.

[Whereupon, at 12:55 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF J. ROGER MENTZ ON BEHALF OF CLAYTON & DUBILIER, INC.

FOR THE SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS OF THE U. S. HOUSE OF REPRESENTATIVES

May 26, 1989

On behalf of Clayton & Dubilier, Inc., we are submitting this statement to the Subcommittee discussing the investment of pension plan assets in leveraged buyouts ("LBOs") and related transactions.

I. INVESTMENTS OF PENSION PLAN ASSETS IN LBOs DOES NOT PRESENT A POLICY PROBLEM

According to Department of Labor statistics[1], pension plans hold approximately 18 percent of total corporate equity and 26 percent of total corporate debt. Corporate equity and corporate debt holdings constitute approximately 36 percent and 27 percent, respectively, of pension plan assets. However, less than 2.5 percent of total pension plan assets are invested in high yield, non-investment grade bonds ("junk bonds"), and less than .5 percent are invested in LBO funds. The amount of pension plan funds involved directly in LBOs is estimated to be somewhere between two and four billion dollars. Thus, the Administration has concluded, correctly, we believe, that investment by pension funds in LBOs is not a policy problem.[2]

II. EXISTING FIDUCIARY SAFEGUARDS ARE ADEQUATE TO PROTECT PLAN ASSETS

Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") governs the regulation of pension plans. Section 404 of ERISA provides special fiduciary responsibilities to which a pension plan's fiduciaries must adhere. Plan fiduciaries are required to discharge their duties "solely in the interest of the participants and beneficiaries" and for the exclusive purpose of: (1) providing benefits to participants and their beneficiaries; and (2) defraying reasonable expenses of administering the plan."[3] An ERISA fiduciary (which includes those individuals or entities who exercise discretionary authority or control over the management of plan assets) is obligated to discharge his or her duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims.[4] This standard requires a higher degree of care than the common law standard applicable to fiduciaries, i.e., a pension plan fiduciary must exercise the care and skill of an expert, rather than that of an ordinary man dealing in his own property.

In addition, pension plan fiduciaries are required by ERISA to diversify the investment of pension plan assets so as to

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[1] Testimony of David M. Walker, Assistant Secretary for Pension and Welfare Benefits, U.S. Department of Labor, before the Subcommittee on Oversight, House Committee on Ways and Means, April 27, 1989, pp. 7-8.

[2] Id. at 2-3.

[3] ERISA section 404(a)(1)(A).

[4] ERISA section 404(a)(1)(B).

minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.[5] Thus, pension plan fiduciaries are required not only to evaluate and monitor the economic merits of each investment but also, to the extent feasible, to diversify a pension plan's assets in light of the composition of the plan's portfolio and its particular needs.

To the extent that an investment in a particular LBO transaction would present undue risks, ERISA's prudent judgment requirement provides a satisfactory safeguard for protecting plan assets. Moreover, there is little evidence that investments in LBOs have put plan assets at more risk than other investments available to pension plans.[6] Indeed, it is acknowledged that such investments are potentially very profitable.[7]

ERISA's pension diversity requirement ensures that a pension plan fiduciary will not invest a large percentage of plan assets in LBOs and related transactions. We believe that any additional restraints or prohibitions on allowable investments would circumscribe the available range of possible income-producing investments that pension plan fiduciaries otherwise would utilize to satisfy ERISA's prudence and diversity requirements.

III. ELIMINATION OF PENSION PLANS FROM LBO INVESTMENT POOLS COULD ADVERSELY AFFECT EXISTING PENSION PLAN ASSETS

If legislation were enacted that discouraged or eliminated pension plans from the pool of available investors in LBOs and related transactions, the value of existing investments would be adversely affected. This would be true even if there were liberal transition rules, because the pool of investors would be reduced. Moreover, allowing pension plans to be investors ensures, to some degree, that fiduciaries of entities representing the long-term interests of millions of U.S. employees and retired persons have a continuing interest in and some voting input with regard to the ownership of U.S. businesses.

IV. INCOME FROM LBO INVESTMENTS SHOULD NOT BE SUBJECT TO UBIT

In response to concerns about unfair competition with taxable businesses from tax-exempt organizations, Congress enacted the unrelated business income tax ("UBIT")[8] provisions in 1950. The UBIT applies to otherwise tax-exempt entities, including qualified pension plans. In general, the UBIT is imposed on the income derived by a tax-exempt organization from any trade or business that is not substantially related to the exempt purposes of the organization. Traditional passive sources of investment income, however, such as dividends, interest,

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[5] ERISA section 404(a)(1)(C).

[6] Staff of the Joint Committee on Taxation, Issues Relating to the Use of Pension Plan Assets in Leveraged Buyout Transactions, April 27, 1989 (JCZ-6-89), p. 15.

[7] Id.

[8] The UBIT provisions are found in sections 511-515 of the Internal Revenue Code of 1986, as amended ("Code").

annuities, royalties and rents are generally excluded from the UBIT.[9]

The characterization of the income from investment in LBOs, either realized as interest on indebtedness or gain on equity investments, as being taxable to otherwise tax-exempt pension plan investors would be an inappropriate utilization of rules intended to eliminate unfair competition by tax-exempt entities. Moreover, it would subject to taxation income from passive investments, the very type of investment activity condoned by Congress since the enactment of the UBIT in 1950. Clearly, the policy behind the enactment of UBIT is inapplicable to LBO investments. We believe it would be inappropriate to extend the UBIT beyond its original scope to tax income from LBO investments because of some general concern with LBOs themselves. We believe the correct approach would be to identify the specific legislative policy concern with LBOs, if any, and then craft a legislative remedy that meets such concern.

V. CONCLUSION

The ERISA provisions require pension fund fiduciaries to make prudent investments to meet the retirement needs of beneficiaries and to diversify pension fund portfolios adequately to secure pension plan retirement income. Any legislation limiting the ability of pension plans to invest in transactions that meet the current strict ERISA standards, or applying UBIT to LBO investments, would unfairly impact the value of existing investments and make more difficult the efficient management of plan assets.

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[9] Under present law, income otherwise not subject to UBIT will be taxed generally only to the extent that the funds used to purchase the income producing property are borrowed. See Code section 514.

STATEMENT OF JACK L. VANDERHEI, PH.D.
EMPLOYEE BENEFIT RESEARCH INSTITUTE
TO
THE SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS
CONCERNING THE ROLE OF PENSION PLANS
IN THE MARKET FOR CORPORATE CONTROL

MAY 26, 1989

Although much of the recent controversy from changes in the market for corporate control has stemmed from leveraged buyouts (LBOs), it is important to realize that a LBO is only one of the ways in which control of a firm can be transferred from a group of shareholders to another entity. This takeover transaction can be accomplished though a number of activities:[1]

- acquisition
  - merger or consolidation of two firms
  - acquisition of stock through tender offers
  - acquisition of assets
- proxy contest
- going private

Going-private transactions are often defensive tactics when managers of a targeted firm attempt to resist the takeover. This arrangement frequently takes the form of a leveraged buyout in which existing management shares the new equity interest with outsiders. The public shareholders are forced to accept cash for their shares while the business is continued by existing and new management. The cash offer price is financed with large amounts of debt.

The short term financial benefit of takeover activity for existing shareholders of the targeted firm has been enormous. W. T. Grimm & Co. estimates that from 1981 to 1986 the total dollar value of the premiums paid for securities involved in change-of-control transactions was $118.4 billion.[2] Although financial economists have attributed the gains from these transactions to "productive entrepreneurial activity that improves the control and management of assets and helps move assets to more productive uses,"[3] there are continuing worries that other parties (such as existing creditors) may be paying for these gains.[4]

Concern over LBOs has been directed towards pension plans in three specific areas: the investment of pension plan assets in LBOs, the relationship between takeover activity and termination of overfunded pension plans and the impact of both of these factors on the Pension Benefit Guaranty Corporation (PBGC). This paper reviews the extant

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[1]Stephen A. Ross and Randolph W. Westerfield, Corporate Finance (St. Louis: Times Mirror/Mosby College Publishing, 1988), p. 690.

[2]Gregg A. Jarrell, James A. Brickley, and Jeffry M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980," Journal of Economic Perspectives vol 2 (Winter 1988), p. 49.

[3]Michael C. Jensen, "The Takeover Controversy: Analysis and Evidence," Midland Corporate Finance Journal 1986, p. 6.

[4]Although there is recent anecdotal evidence to the contrary, the results from a sample of 108 LBOs from 1980 to 1984 indicate no evidence that losses from preferred shareholders or bondholders are used to create increased shareholder value. See Kenneth Lehn and Annette B. Poulsen, "Sources of Value In Leveraged Buyouts," in Public Policy Towards Corporate Takeovers (New Brunswick, New Jersey: Transaction Publishers, 1987).

literature for evidence of the role of pension plans in the market for corporate control to provide additional information on the likely impact of each of these cases.

PENSION PLAN INVESTMENTS IN LBOS

Although estimates from the witnesses providing oral testimony for this hearing have varied, it appears safe to conclude that pension plan investments in all LBO related activity (LBO funds and "junk" bonds) represent less than 5 percent of total pension assets. There also appears to be a tendency, at least among the larger plans, for state and local plans to invest larger absolute dollar amounts in this type of investment than their private pension fund counterparts. Even in a worst-case scenario it is unlikely that existing levels of LBO investments would impair the benefits of participants, the financial solvency of the pension plans or the long run profitability of the sponsor.

Still, some commentators have suggested an outright ban on the investment of pension plan assets in LBO related activity. The impact of imposing such restrictions would depend to a large extent on the ability of pension plan investment managers to substitute other assets with similar risk and return characteristics in their portfolios. Although there is currently insufficient data on the risk and return characteristics of LBO related investments to perform a detailed analysis, it may be useful, given the obvious similarities, to review the analysis performed by Westerfield[5] for restrictions previously suggested via social investing.

The analysis suggests that the capital asset pricing model[6] may be utilized to assess the cost of social investing in the following procedure:

1. Choose a proxy for a market portfolio which includes the universe of investments deemed relevant for pension plans.
2. Exclude all assets that are considered socially undesirable.
3. Identify the most efficient portfolio from the remaining assets.
4. Compute the correlation of returns of the portfolio in step 3 with the portfolio in step 1.
5. Compute the cost of social investing based on returns, standard deviation, and correlations.[7]

Westerfield applied this analysis to Pax World Fund, an open-end investment company that avoids investing in the securities of firms that do business in liquor, gambling, weapons and defense contracts. His analysis of the fund's results from 1975-1981 yielded a cost attributable to diversification constraints of .34 percent and an overall cost of .14 percent.

PENSION PLAN TERMINATIONS IN LBOS AND RELATED TRANSACTIONS

Corporations have been known to use recaptured plan assets in the financing of corporate takeover and anti-takeover activities. Several firms have terminated overfunded pension plans of newly acquired companies such as Mobil Corporation's $29 million recapture from Superior Oil and St. Regis $88 million recovery from Champion International.[8] Reversions have also been reported when a company is threatened by a hostile takeover and wants to prevent excess plan assets from being used as a possible source of financing the takeover. For many financial economists the notion that post-takeover reversions should be prohibited or constrained is somewhat puzzling given (a)

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[5]Randolph Westerfield, "Capital Market Perspectives," in Social Investing Dan M. McGill, ed., (Homewood, Illinois: Irwin for the Pension Research Council, 1984):107-129.

[6]William Sharpe, Capital Asset Prices: A Theory Of Market Equilibrium Under Condition Of Risk, Journal of Finance (September 1974):425-442.

[7]See Westerfield, p. 119 for the equation.

[8]Lynn Asinof, "Excess Pension Assets Lure Corporate Raiders." Wall Street Journal (September 11, 1985): 6ff.

that participants receive the full accrued benefit to which they are legally entitled and (b) the conventional wisdom that the overfunding is already imputed in share price.

Before exploring the empirical evidence on this topic, it is important to note that there may be other reasons for a post-takeover reversion such as a desire to switch from a defined benefit to a defined contribution pension plan or the added efficiency of standardizing pension plans for all employees of the employer after a takeover. Unfortunately there is not sufficiently detailed data available at the current time to assess properly the significance of each factor.

INCIDENCE OF CORPORATE OWNERSHIP CHANGES AMONG SPONSORS TERMINATING OVERFUNDED PENSION PLANS

An SEC study by Mitchell and Mulherin finds no systematic evidence that takeovers are a primary cause of pension terminations.[9] Out of a sample of 313 terminations from 1980-1987, 34 cases were found in which the termination occurred within a year following an actual change in corporate ownership of the plan sponsor. The authors compare this rate of 10.9 percent to the 21.9 percent of a general sample of 1158 firms (not necessarily sponsors of terminated pension plans) that were acquired during the same time period.[10] The sample involved pension plans of 32 target firms of which only five were acquired in hostile takeovers. The authors conclude that "this evidence suggests that pension plan terminations do not disproportionately follow corporate takeovers." On average, the reversion for the takeover sample accounted for only 7.3 percent of the purchase value of acquisition.

It should be noted however that the 10.9 percent rate reported by the authors is not directly comparable to the GAO's finding that almost 40 percent of the 190 companies taken over in LBOs between 1982 and 1987 terminated pension plans after the takeover.[11] The GAO analysis included terminated defined contribution plans as well as defined benefit plans terminated prior to and more than one year after the LBO. A more appropriate comparison would be the percentage (5.9 percent) of defined benefit terminations occurring within one year after the LBO (39) to the total number of defined benefit plans (656) for the 190 LBO companies studied.

Expanding the analysis to consider unsuccessful takeover attempts as well, the SEC authors found that 25 percent of the reversion sample had been involved in some type of takeover attempt (either successful or unsuccessful). Again, this was actually a lower incidence than that found among the general population by Mitchell and Lehn (40 percent). A total of 64 (36) percent of the takeover attempts for the reversion sample was associated with hostile (friendly) takeover bids. The authors conclude that "even within this broader perspective, the large majority of pension terminations are not associated with corporate takeovers."

STOCK PRICE STUDIES

Additional evidence on this question can be obtained from the event studies that measure the effects of reversions on stock prices, after correcting for overall market

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[9]Mark L. Mitchell, and J. Harold Mulherin, "The Stock Price Response to Pension Terminations and the Relation of Terminations with Corporate Takeovers," Financial Management (forthcoming).

[10]Mark L. Mitchell and Kenneth Lehn, "Do Bad Bidders Become Good Targets," mimeo. U.S. Securities and Exchange Commission (1988).

[11]Testimony of Joseph F. Delfico, Director of Income Security Issues, Human Resources Division, United States General Accounting Office, before the Subcommittee on Oversight Committee on Ways and Means, House of Representatives, April 27, 1989.

influence on stock returns. Alderson and Chen[12] argued that stock price responses to reversions could be used to test whether pension assets are distinct from the assets of the firm that is sponsoring the defined benefit plan (separation hypothesis) or inseparable from such assets (integration hypothesis). They predicted that an excess asset reversion would affect stock prices under the separation hypothesis if plan termination could not be accurately predicted. Under the integration hypothesis, they predicted that stockholders would not be affected by termination. Their estimates of large positive returns to shareholders around the legal date of the termination for all reversions in excess of $1 million between 1980 and 1984 were interpreted as providing support for the separation hypothesis. In other words, when considered on an aggregate basis, shareholders of firms sponsoring overfunded pension plans could expect a short term profit for the termination and recapture of excess assets. However, no separate analysis was provided for those reverting due to change in corporate ownership.

VanDerhei[13] also estimated abnormal returns associated with reversions using the Form 5310 filing date as the event date.[14] The results indicated a significantly positive abnormal aggregate rate of return for publicly-traded firms involved in a reversion in excess of $1 million between 1979 and 1983. However, this study went further to address the area of a change in ownership. When analyzed by self-reported reason for termination, the five firms terminating due to ownership change did not produce significant abnormal returns around the announcement day. Cross-sectional regression analysis of abnormal returns were also conducted and the results suggest that shareholder's gains were positively related to the firm's debt-equity ratio and the amount of excess assets and negatively related to the cash flow generated by the firm.

Preliminary findings from Alderson and VanDerhei[15] have extended this type of analysis to include more recent reversion activity. This study confirms that in aggregate the firms undergoing a reversion receive abnormally high returns. When the results are stratified by self reported termination reason, the returns for 52 firms reverting due to ownership change are not statistically significant. This finding is confirmed in cross sectional regression analysis on the abnormal returns. Although variables measuring financial distress and relative reversion size are both significantly greater than zero, the variable for ownership change was insignificant.

These findings suggest that while the average price increase for shares of firms reverting their excess assets is positive, there is no evidence that a reversion accompanied with a change in corporate ownership benefits the firm's shareholders in the short term.

PREDICTION STUDIES

Perhaps the most relevant results for this topic are contained in Mittelstat's[16] takeover prediction model of firms acquired between 1/1/81 and 12/31/83. Based on a series of financial variables, each sponsor of an overfunded defined benefit plan in his study was assigned a value -- the higher the value the greater the probability of being

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[12]Michael J. Alderson, and K. C. Chen. "Excess Asset Reversions and Shareholder Wealth." Journal of Finance 41 (March 1986): 225-241.

[13]Jack L. VanDerhei, "The Effect of Voluntary Terminations of Overfunded Pension Plans on Shareholder Wealth," Journal of Risk and Insurance, 54 (1987), 131-156.

[14]The administrator of a terminating plan must file a termination report with both the Department of Labor and the Pension Benefit Guaranty Corporation (PBGC). IRS Form 5310 commonly is used for this purpose.

[15]Michael J. Alderson and Jack L. VanDerhei, "Excess Asset Reversions and Securities Returns," (1989) Working Paper.

[16]H. Fred Mittelstaedt, "An Empirical Analysis Of The Factors Underlying The Decision To Make Extreme Reduction In Pension Plan Funding," Arizona State University (October 1988) Working Paper.

acquired. The average values were much lower for sponsors that maintained their overfunded plans then those that terminated. This result would be expected if sponsors of overfunded pension plans used reversions as a defensive tactic when they had been (or where perceived to be) targeted as a possible takeover.

Three additional studies have used statistical analysis to measure the quantitative relationship between the likelihood that a sponsor will terminate an overfunded plan and characteristics of the plan sponsor and the pension plan. In particular, the regression analysis conducted by Hamdallah and Ruland[17], Harrington and VanDerhei,[18] and Stone[19] each showed a significantly positive relationship between reversions and financial leverage. This finding is important because firms involved in hostile takeovers often undergo massive financial restructuring that results in highly leveraged positions. These results suggest that continuing LBO activity leading to increasing financial leverage could result in increased reversion activity. However, it is important to note that each of these studies used a sample period that ended prior to the 10-percent excise tax on reversions added by the Tax Reform Act of 1986 (later increased to 15 percent by the Technical and Miscellaneous Revenue Act of 1988). To the extent that this increase in the penalty tax is not offset by decreases in the effective corporate tax rate,[20] the increased cost of "borrowing" from the pension plan may decrease the importance of the leverage variable in explaining more recent reversion activity. Moreover, the reduced full funding limitation imposed by the Omnibus Budget Reconciliation Act of 1987 will tend to reduce the magnitude of overfunding in the future.

PENSION PARACHUTES

Conceptually similar to poison pill provisions that are designed to defend against acquisition attempts, a pension parachute is designed to provide either all or a portion of excess pension assets to current participants in the form of increased pension benefits. Mitchell and Mulherin identified the exact dates when investors became aware that parachutes had been adopted for each of 10 firms. The average three-day rate of return for the shareholders (after controlling for market effects) around the adoption date is a statistically significant loss of 2.01 percent. Although this suggests a sizeable reduction in share price, the results must be interpreted carefully due to the small sample size and the possibility of confounding events. For example, companies may have instituted other antitakeover provisions around the time the parachutes were adopted.[21]

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[17]Ahmed El-Sayed Hamdallah And William Ruland, "The Decision to Terminate Overfunded Pension Plans," Journal of Accounting and Public Policy, 5 (Spring 1976): 77-91.

[18]Scott E. Harrington, and Jack L. VanDerhei. "Internal vs. External Financing in Credit Markets with Asymmetric Information: The Case of Pension Plan Asset Reversions." Pension Research Council Working Paper Series, Number 87-3, (December 1987).

[19]Mary Stone, "A Financing Explanation for Overfunded Pension Plan Terminations," Journal of Accounting Research Vol. 25, No. 2 (Autumn 1987):317-26.

[20]Even though the Tax Reform Act of 1986 reduced the maximum corporate tax rate, many firms receiving reversions had tax loss carryforwards that effectively shielded the sponsor from the tax. See In-Mu Haw, William Ruland, and Ahmed Hamdallah, "Investor Evaluation of Overfunded Pension Plan Terminations," Journal of Financial Research, Vol. XI, No. 1 (Spring 1988): 81-88. Carryforwards will not offset the penalty tax however.

[21]See for example Gregg A. Jarrell and Annette B. Poulsen, "Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980," Journal of Financial Economics 19 (1987): 127-168.

IMPACT ON THE PBGC

The long run impact of corporate control changes on the PBGC will likely depend on the relative tradeoff between changes in the sponsor's exposure (i.e., underfunding) and the probability of an insured event (i.e., bankruptcy of the sponsor) for the companies involved in these transactions. As mentioned earlier, pension plan investments in LBO related activity does not appear to be a major problem due to its relatively small magnitude for most portfolios. However, many commentators have suggested that LBO transactions, when accompanied by excess asset reversions, will necessarily increase the expected claims for the PBGC due to the removal of any buffer for adverse investment experience or future funding waivers. This ignores the possibility that a LBO may actually decrease the likelihood that a sponsor will eventually be forced into bankruptcy and hence present a claim to the PBGC if the pension plan is not sufficiently funded at the time. Unfortunately there currently is not sufficient data available to assess whether LBO activity (with or without an accompanying reversion) will result in the entity being able to better meet its long-run pension obligations.

PENSION RIGHTS CENTER

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STATEMENT
OF THE
PENSION RIGHTS CENTER
TO THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
APRIL 27, 1989

The Pension Rights Center is a thirteen year old public interest group which promotes and protects the interests of workers, retirees and their families. We are grateful that the Subcommittee is holding this hearing today to explore the role of pension money in leveraged-buyouts and takeovers. We hope this hearing will lead to the enactment of legislation that will stop the "milking" of pension plans for corporate profit.

Over the past few years the Center has been working with thousands of union and salaried workers and retirees whose pension plans have been raided. These people are bewildered and outraged that takeover artists have been able to finance their "wheelings and dealings" with their pension money. Workers and retirees rightly wonder whether the availability of these funds actually provides an artificial economic incentive which encourages many of the leveraged-buyouts now wreaking havoc on the economy.

The case of the Pacific Lumber Company in Scotia, California vividly demonstrates why pension plan raiding must be stopped immediately. From press accounts, the case involves all the elements of a classic Wall Street scandal replete with stock-parking schemes, insider trading deals and, not surprising, Ivan Boesky.

Up until 1986, Scotia California was a sleepy company town owned by the paternalistic, hundred year old Pacific Lumber company. But that changed overnight when Texas corporate raider Charles Hurwitz rode into town with his band of raiders, ripping apart the company, the redwood forests and the pension plan.

According to Bill Bertain, attorney for former shareholders of Pacific Lumber, Hurwitz and his Maxxam company arranged junk bond financing to buy the company through Michael Milken and Drexel Burnham Lambert. The largest share of Drexel Burnham junk bonds were bought by First Executive Life Insurance company which is reportedly owned, in part, by Milken and his family. The rest of the $1 billion deal was financed by other junk bond purchasers and a $300 million bank loan.

When Pacific Lumber board of directors learned of the hostile takeover attempt by Maxxam, they amended the pension plan to prohibit it from being raided, according to Bertain. Prior to convincing the old board of directors into making it a friendly rather than a hostile takeover, Hurwitz sued to get access to the rich pension pool. Only four days after the lawsuit was filed, Pacific Lumber agreed to the merger, thus giving "free" access to the pension plan.

Once the plan was amended, Hurwitz lost no time siphoning off $50 million from the pension plan to help pay off the debt incurred in buying the company. Then, in a highly controversial move, Maxxam bought annuities to cover the already-earned benefits of workers and retirees from First

Executive Life Insurance company -- the very same insurance company which helped finance the deal in the first place and which is largely backed by junk bonds.

Pacific Lumber executives objected to the contract with First Executive because of its apparent conflict-of-interest position and heavy reliance on high-risk financing. But the deal went through.

Although First Executive Life boasts of a high insurance rating, a recent article in the San Francisco Chronicle raises serious questions about its solvency. The article says that the company has been "trailed by a wake of improprieties, unsettling allegations and questions about its real financial condition." According to Indiana University insurance professor Joseph Belth, "Executive Life would have been insolvent at the end of 1987 had the California Department of Insurance not allowed the company to include in its financial statement assets that appeared to have been backdated."

Pacific Lumber retirees and workers rightly fear that their retirement security is now on shaky ground. If First Executive Life were to go bankrupt, hundreds of workers and retirees would lose their pensions that are no longer protected by the Pension Benefit Guaranty Corporation. According to Professor Belth, many of the Drexel Burnham Lambert transactions involve First Executive Life Insurance Company.

Bill Hunsaker has an insider's view of how the raid on the pension plan has already devastated the retirement income security of retirees and workers. Hunsaker worked for the company for 40 years. He worked himself up from mailboy to the Vice president of Administration. He knows how people have been hurt because he was the pension plan manager for 20 years, from 1964 until 1984, when he retired.

According to Hunsaker, the existence of the "surplus" in the pension fund was no accident. He said the plan intentionally used conservative actuarial assumptions so that the return on plan investments would exceed their estimates. In the past Hunsaker says that "surplus" assets were used for benefit improvements for active workers and to provide necessary cost of living adjustments to retirees. The company intended to give retirees', what they called, "plus ups" every four years to help ameliorate the impact of inflation. By keeping a "surplus" in the fund, the plan was sheltered from the fluctuations of the stock market. There was always enough money to properly fund benefits and provide cost of living adjustments to the retirees.

Hunsaker says he was "literally sick " when the Maxxam group took over the company and robbed the fund. He says, "I've seen the company liquidated and soon there won't be anything left. They stole the pension money, sold off the assets and they're cutting timber as fast as it can be harvested....they've taken 10 years of life out of the company in two years."

Pacific Lumber is only one example of how pension money has been used in takeover situations. According to C.W. Gilbert, a 78 year old retiree, the American Standard company used $12 million from the pension plan to help finance a leveraged-buyout. In early 1988, Black and Decker tried to take over American Standard in a hostile takeover. Reportedly, American stashed away $130 million for golden parachutes, spent $30 million to try to stave off the takeover and finally fended off the raid by an LBO managed by Louis Kelso. According to the AFL-CIO, the cost of buying back shares increased the company debt from a few hundred million to over $2 billion.

When the plan was raided, American Standard purchased fixed pensions for its retirees. Gilbert, who worked for the company 51 years, lives on a pension which buys about 54% of what it originally bought in 1975 when he retired. In ten years, even at low 4% inflation, the value will be cut in half. Gilbert contends that the "surplus" in the fund was partly created because the retirees were paid out in devalued dollars while the plan reaped returns in current dollars.

The Getty-Texaco scenario illustrates the detrimental impact of plan raiding. Art Wilson, the President of the Oil, Chemical and Atomic Workers Union, Local #8-898 in Delaware, says that Texaco stole some $250 million from the former Getty employees. According to Wilson, Texaco used the money to pay for greenmail, the Penzoil lawsuit, and a proxy fight with Carl Ichan.

In the past, the "surplus" afforded Wilson the opportunity to bargain for better benefits for workers and cost of living adjustments for retirees. Texaco put the Getty workers under their own pension plan. What this amounts to, according to Wilson, is that all of his members have worked the past four years without accumulating additional pension benefits.

P.N. Slough of St. Louis, Missouri says that Carl Icahn used nearly $27 million of the Ozark pension plan when it was taken over by TWA. The pilots regularly got cost of living adjustments in their pensions when the Ozark plan was operating. Now they are living on fixed pensions which rapidly erode from inflation.

In each of these cases, workers and retirees contend that the easy access to their pension money helped create an incentive for a takeover of their company. Even though the amount drained from a pension plan may be relatively small in relation to the takeover price, it represents hard, upfront cash which fuels the transaction.

An example which clearly highlights the role that surplus plays in these transactions is the Schick company's takeover of Reeves in North Carolina. The Reeves company had $20 million in its pension plans. In order for Schick to convince nine banks to loan it the money it needed to buy Reeves, Schick stipulated in its agreements with the banks that it would terminate the plans as soon as practicable to repay the loans. The amount of the surplus was exactly the amount needed to repay the banks.

Unlike most other cases, the Reeves situation had a happy ending. The Amalgamated Clothing and Textile Workers Union organized an effective public relations campaign which convinced the banks to back off. The surplus instead was used to provide workers with 40% increases in their benefits.

Since 1980, when the practice of "plan raiding" started, more than $20 billion has been taken out of nearly 2,000 pension plans. Not all of these involve takeovers. But, even where there is no takeover, companies have been siphoning money out of pension plans that is needed for ongoing funding for the plan and to provide much-needed cost of living adjustments for retirees. To give the most outrageous recent example, the humanitarian American Red Cross has announced its intention to bleed its plan of $400 million. Red Cross retirees are organizing around the country to stop this practice.

There are some 600 companies waiting on the sidelines to get access to surplus pension money. They are waiting for the Treasury moratorium to expire on May 1. We urge you to pass legislation immediately to stop the practice of reversions.